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Tax Policy

California has seen a number of significant tax developments in 2016. In this article, Bradley R. Marsh and William H. Gorrod of Greenberg Traurig LLP discuss these tax changes and their implications.

California Tax Activity: What CPAs Should Be Aware of in California

BY BRADLEY R. MARSH AND WILLIAM H. GORROD

During 2016, California has experienced some significant developments in tax law through ballot propositions, legislation, administrative guidance, and judicial and administrative cases. These developments are summarized below.

Budget and Ballot Propositions

The Golden State annually increased tax revenue between 2008, when tax receipts were $95 billion, and the 2016-17 budget that included tax revenue projections at $121 billion. Some of this growth is attributable to economic recovery. Some of it is also due to tax increases, such as Proposition 30 passed in 2012. In spite of this increase, however, there continues to be no shortage of items vying for additional funding.

Bradley R. Marsh is a shareholder with Greenberg Traurig, LLP. William H. Gorrod is a shareholder with Greenberg Traurig, LLP.

In November 2016, there were numerous tax increases on the ballot in the form of propositions. Thus, in spite of how ''rich'' the revenue may seem in comparison to recent years, there have still been a number of very interesting tax changes and increases in California this year.

The November 8 ballot propositions that California passed include:

- Proposition 55, an extension of the personal income tax increases in Proposition 30;
- Proposition 52, a Hospital Tax;
- Proposition 56, a Tobacco Tax Increase; and
- Proposition 64, which will increase taxes on legalized recreational marijuana.

Each of the largest tax measures all passed. This appears to continue a trend where voters statewide are comfortable passing tax laws that are either ''sin taxes,'' or the taxes they believe will not directly affect them.

California Tax Legislation and New Legislature

The California Legislature's regular sessions ended without direct broad-based tax increases. Many insiders had predicted that with the Democratically controlled California Legislature and a strong Democratic governor some dramatic changes would be on the horizon, such as a property tax split roll or an expansion of sales tax on services.

During the last year, the California Legislature enacted several pieces of tax legislation, including a restructured Managed Care Organization (''MCO'') Tax package and a tax amnesty program for the medical

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cannabis industry. Under the MCO tax legislation, which is effective from July 1, 2016 through July 1, 2019, the new MCO tax is imposed on all health plans and provides certain exclusions from gross income for California corporation franchise tax purposes. In addition, affiliate insurers are subject to a reduction of the California gross premiums tax rate to zero percent.

Under the medical cannabis industry tax amnesty program, the California State Board of Equalization is required to develop and administer a sales and use tax amnesty program open for the six month period of July 1, 2017 through December 31, 2017 and applicable to sales and use tax liabilities for reporting periods beginning before January 1, 2015. Medical cannabis-related businesses that come into compliance under the amnesty program are eligible for waiver of all tax penalties and a prohibition against criminal action for noncompliance with sales and use tax requirements.

The governor also signed AB 2476, which requires the legislative body of any local agency to provide notice of a new parcel tax to the owner of a parcel affected by the tax, if that owner does not reside within the jurisdictional boundaries if the taxing entity. This is seen as a small, but important, victory for owners of vacant land and business property who do not vote on the local taxes. They are often times unable to challenge them in court unless they do so immediately after the enactment of those taxes because of California's validation laws.

As we move toward the next legislative session, it appears that Democrats will hold a supermajority in both houses of the California Legislature. The closest election was a battle in which Democrat Josh Newman appeared to win the election with just a few thousand votes in the Senate District 29 race. Democrats now hold 27 seats in the Senate, the exact number of votes needed to pass bills requiring two-thirds approval. Democrats will hold 55 seats in the Assembly, one more seat than is necessary to meet the two-thirds threshold. This means that in the next legislative session, Democrats can pass taxes and put Constitutional changes on California's ballot without a single Republican vote.

California Franchise Tax Board Guidance

In addition to the tax legislation enacted by the California Legislature, the California Franchise Tax Board (''FTB'') provided additional corporation franchise tax guidance. Notably, the FTB promulgated the long-proposed market-based sourcing regulations for sourcing sales of other than tangible personal property (*i.e.*, intangible property). Section 25136-2, title 18 of the California Code of Regulations, which was approved on September 15, 2016 by the Office of Administrative Law, clarifies the receipts factor market-based sourcing rules for marketable securities, dividends, goodwill, and interest. Notably, the final version of the regulation did not include two examples regarding the sourcing of asset management fees which had been included in prior versions of the proposed regulation.

On September 9, 2016, the FTB issued Notice 2016-02 to provide guidance regarding the treatment of a water's edge election when a unitary foreign affiliate of the water's edge combined reporting group becomes a taxpayer because it is doing business in California under the factor presence economic nexus standard adopted for tax years beginning on or after January 1, 2011. Generally, a California water's edge election is only effective if all members of the combined reporting group that have nexus and are subject to California taxation make the election.

To summarize, the FTB issued the Notice in response to taxpayer concerns that foreign affiliates meeting the factor presence nexus standard of $500,000 of California sales (indexed annually) could risk the water's edge election where non-electing foreign affiliates have nexus with California as a result of the subsequent enactment of the factor presence nexus standard in 2011. FTB Notice 2016-02 states that a unitary foreign affiliate is deemed to have participated in, or subsequently elected into, the combined group's water's edge election, if certain requirements are met, in the tax year in which they became a California taxpayer (assuming that the entity did not otherwise have California nexus, except for the factor presence standard). As such, the date of the deemed water's edge election is consistent with the existing group's water's edge election. However, FTB Notice 2016-02 does not provide guidance regarding a foreign affiliate that did not participate in the water's edge election and whose subsequent physical presence within California creates nexus, rather than creating nexus based on the factor presence nexus standard.

In addition, the FTB recently issued administrative guidance, FTB Notice 2016-03 (Nov. 1, 2016) regarding the courses of action that the FTB intends to take for Multistate Tax Compact election cases. By way of background, on December 31, 2015, in *Gillette v. Franchise Tax Board*, 62 Cal.4th 468 (Cal. 2015), the California Supreme Court determined that taxpayers could not elect to use the Multistate Tax Compact's (''MTC'') equally weighted three factor apportionment formula, rather than the statutory double-weighted apportionment formula under the prior version of the California Revenue and Taxation Code. The taxpayers filed a *writ of certiorari* requesting discretionary review by the United States Supreme Court, which the Supreme Court denied on October 11, 2016.

The FTB's matters regarding the MTC election had been on hold, and FTB Notice 2016-03 provides that the FTB will resume denying such refund claims, return administrative appeals to active status, and resume processing audits regarding the MTC election. The Notice provides that the FTB will seek to impose penalties as appropriate on a case by case basis.

California Judicial and Administrative Case Law

In *926 North Ardmore Avenue LLC v. County of Los Angeles*, Cal. App. Ct. No. B248536 (Sep. 22, 2014), the California Court of Appeal for the Second District determined that a county may imposed documentary transfer tax on a transfer of interests in a legal entity if the transfer results in a ''change of ownership'' for real property tax purposes. On January 14, 2015, the California Supreme Court accepted the taxpayer's appeal for review and the case is currently pending with the court.

California has long audited taxpayers in 1031 transactions and taken positions that were not consistent with IRS positions. The State Board of Equalization,

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however, changed the trend by deciding in favor of the taxpayer in *Rago Development Corporation* (June 23, 2015) on a ''swap-and-drop'' transaction. The FTB has, since this decision, taken steps to bring their audit issues and standards closer to those of the IRS.

Currently, under California law, businesses operating wholly in California may choose to file on a separate or combined basis, but interstate companies must file on a combined basis. In both *Harley-Davidson Inc. v. Franchise Tax Board*, No. 37-2011-00100846-CU-MC-CTL (Oct. 31, 2016), and *Abercrombie & Fitch v. Franchise Tax Board*, No. 12CECG03408 (Oct. 31, 2016), courts recently ruled against taxpayers in the issue of whether, for interstate filers, companies may file on a separate return basis. This is a development that we recommend following in 2017 when both decisions are expected to be appealed.

Local Taxes

On November 8, San Francisco, Oakland, and Albany each passed ''soda taxes,'' joining Berkeley as the four cities in California that have adopted such taxes. Also, across the state, there were as many as 60 local sales tax increases at the city and county levels that are projected to cost taxpayers more than $700 million annually. Thirteen hotel tax increases will take affect across the state, and at least 31 new local marijuana taxes were also enacted.