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New Taxes Break The California Budget Impasse

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The California legislature passed the Budget Act of 2008 (the "Legislation") Thursday, February 19, 2009, and Governor Schwarzenegger signed it Friday, February 20, 2009. The Legislation contains several important revisions to the California Revenue and Taxation Code (the "Code"). This update summarizes some of the more noteworthy revisions.

Income Tax

Corporate Income Tax

The Legislation introduces a new standard for determining whether a corporation is "doing business" in California for the purposes of the franchise tax. In addition, the Legislation substantially revises the calculation of the sales factor for apportionment of income to California and permits certain taxpayers to elect to apportion their income based on a single sales factor. Finally, the Legislation provides a tax credit for motion picture companies.

- Doing Business in California: Economic Nexus

The Legislation has expanded the scope of the definition of "doing business" in California by codifying an economic nexus standard. Where the Code previously simply defined "doing business" as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit," the Legislation adds several specific conditions based on the apportionment factors, which, if met, define the taxpayer as "doing business" in the state. In particular, a taxpayer is "doing business" in California if the taxpayer's:

1) sales in the state exceed $500,000 or 25% of the taxpayer's total sales, whichever amount is less;

2) property in the state exceeds $50,000 or 25% of the taxpayer's total property, whichever amount is less; or

3) payroll in the state exceeds $50,000 or 25% of the taxpayer's total payroll, whichever amount is less.

This provision is effective for taxable years beginning on or after January 1, 2011.

- Sales Factor

The Legislation permits taxpayers to elect to apportion their income to California based on a single sales factor in lieu of the previously applicable three-factor formula of property, payroll, and double-weighted sales. All taxpayers are eligible to make this election, except those that, under the previous Code, used a three-factor formula with a single-weighted sales factor.

The election must be made on an "irrevocable annual" basis, and is available for taxable years beginning on or after January 1, 2011.

Certain other provisions of the Legislation impact whether it will be advantageous for any particular taxpayer to make this election.

First, the Legislation reverts back to the *Finnegan* rule and retains the previously applicable throwback provision. Accordingly, the numerator of the sales factor will now include all sales of the combined or unitary group assignable to California regardless of whether the member of the group that made the sale is taxable in California.

Second, the Legislation modifies the definition of "gross receipts" for sales factor purposes to exclude a number of items related to financial transactions. Some of these receipts have previously been excluded by Franchise Tax Board regulation or policy (e.g., gross receipts from treasury function).

Finally, the Legislation changes the sourcing rule for intangible property and services to adopt a market approach in lieu of the previously applicable cost-of-performance approach. Thus, sales of intangible personal property will generally be sourced to California if the property is used in the state, and services will be sourced to California if the benefit of the service is in the state.

All of these provisions are applicable for taxable years beginning on or after January 1, 2011.

- Motion Picture Company Credit

The Legislation introduces a new credit for motion picture companies in the amount of 20%, for a motion picture, or 25%, for an independent film or a television series, of the production expenses of the motion picture. Taxpayers must apply to the California Film Commission for the credit and receive a credit allocation from the Commission. Allocable credits are limited to $100 million.

These provisions are applicable for taxable years beginning on or after January 1, 2011.

Personal Income Tax

The Legislation increases the personal income tax rates by 0.25% for taxable years beginning on or after January 1, 2009 and before January 1, 2013, or January 1, 2011, as described below. In the event that California receives specified funds from the federal government before June 30, 2010, the rates will be increased in the reduced amount of 0.125%.

The Legislation also increases the alternative minimum tax rate by 0.25% to 7.25% for taxable years beginning on or after January 1, 2009 and before January 1, 2013 or January 1, 2011, as applicable. As with the personal income tax rate increase, in the event that California receives specified funds from the federal government before June 30, 2010, the rates will be increased in the reduced amount of 0.125% to 7.125%.

These provisions will cease to be operative for taxable years beginning on or after January 1, 2013, if the electorate approves an amendment to the California Constitution that limits the total amount that may be transferred by statute from the Budget Stabilization Account to the General Fund. If the amendment fails, the provisions will cease to be operative for taxable years beginning on or after January 1, 2011.

The Legislation introduces a credit for the purchase of a newly constructed principal residence purchased between March 1, 2009 and March 1, 2010 in the amount of $10,000 or 5% of the purchase price, whichever amount is less.

Sales and Use Tax

The Legislation increases the sales and use tax rates by 1% to 8.25%, effective April 1, 2009. These provisions will be effective through July 1, 2012, if the electorate approves an amendment to the California Constitution that limits the total amount that may be transferred by statute from the Budget Stabilization Account to the General Fund. If the amendment fails, the provisions will cease to be effective on July 1, 2011.

Miscellaneous Issues: *Vehicle License Fee*

The Legislation increases the current license fee rate for vehicles, other than commercial vehicles, from 0.65% to 1.15%. This increase will apply on and after May 19, 2009, and will expire on July 1, 2013, if the electorate approves an amendment to the California Constitution that limits the total amount that may be transferred by statute from the Budget Stabilization Account to the General Fund. If the amendment fails, the provision will cease to be effective on July 1, 2011.

If you have any questions or would like further information on these developments, please contact: Eric Coffill, ECoffill@mofo.com; Scott Reiber, SReiber@mofo.com; Carley Roberts, CRoberts@mofo.com; Tom Steele, TSteele@mofo.com; or Andres Vallejo, AVallejo@mofo.com, of Morrison & Foerster's State and Local Tax group.