tax analysts viewpoint

Notes From California's Tax Trenches

by Robert W. Wood

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Truly, California is the Golden State. It is golden in many ways: in weather, in promise, and in resources. Cynics may say that the state, particularly its nether regions, is golden in other ways too — richly populated by famous people who often have a golden hue. But one thing the Golden State is not these days is flush with cash. Currently, its coffers and overall financial state are leaden.

That means its taxing agencies are more stretched and more stretching than usual. If you or your clients pay tax in California — or should be paying tax in California (and state officials think there are many in the latter category) — you or they are more likely to be drawn to the Golden State's tax agencies than in the past. Feeling like a stranger in a strange land can be unsettling.

Some California tax specialists handle solely California tax matters. However, the bulk of those tax lawyers and accountants must be versed in both federal and state tax law. And unlike many states, California has its own cherry-picking system of conformity (using the term loosely) with federal law.

That can cause problems. Yet it is the administrative and procedural aspects of California tax law that are in many ways more confusing and threatening. When one talks to businesspeople, the procedural oddities can be hard to explain.

Inevitably, those of us in California are asked about the state tax aspects of the deal, the partnership, the development, or the controversy. There are sales and use taxes, property taxes, nexus questions, residency questions, and procedural oddities. Even if the client's tax matter is primarily federal, there may be California implications during or after the federal matter. Many are not immediately obvious.

In a prior article, I suggested that every tax adviser and businessperson having a passing connection to the Golden State should know 10 things.[1] A shortened reprise follows:

A. The First 10

1. Four years, not three. Unlike the basic federal tax statute of limitations of three years, the California Franchise Tax Board has a four-year statute.[2]

2. When the statute never runs. California, like the IRS, gets an unlimited amount of time to come after you if you never file a tax return, submit a false or fraudulent return, or fail to notify the FTB within six months if the IRS changes your tax liability.[3]

3. Give the FTB more time. The FTB may contact you to ask for more time to examine your tax return. Some taxpayers just say no, but that often triggers an assessment, so you should usually agree.

4. Compromising California taxes. While there is a lot of hype regarding "pennies on the dollar"-type deals with the IRS, don't expect any miracle deals in California. Most California tax professionals believe that a California tax controversy generally is much harder to settle than a federal one.

5. No Tax Court. Unlike some states, California does not have a Tax Court; instead, it has the State Board of Equalization. The five-member board functions much like a court, hearing appeals and counterarguments in tax disputes.[4]

6. Voting of BOE members. The five members of the BOE are not judges, and most of them are not tax professionals. It's OK to talk to them ex parte, and in fact, it is common for most tax professionals to seek out and lobby individual BOE members before a hearing.

7. No votes and disqualification. Any contribution of $250 or more to a BOE member must be disclosed.[5]

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[1]*See* Robert W. Wood, "Notes From California's Tax Trenches," *Tax Notes*, Jan. 11, 2010, p. 247, *Doc 2009-27990*, or *2010 TNT 7-9*.

[2]Calif. Revenue and Taxation Code section 19057.

[3]Calif. Revenue and Taxation Code section 19087.

[4]Calif. Revenue and Taxation Code section 7093.5.

[5]Cal. Gov. section 15626.

If you donate to a BOE member, he will be disqualified from considering your case unless he returns the contribution within 30 days from the time he knows about it. Using this maneuver can disqualify members who could vote against you, and could turn the odds in your favor!

8. 'One-way' appeal and going to court. If a taxpayer wins before the BOE, the FTB cannot appeal to another body. However, if the FTB wins, the taxpayer can still bring suit before the California Superior Court.[6] Be warned, however, that unlike Tax Court judges, Superior Court judges are not tax specialists.

9. Sales and use taxes. The BOE (the agency, not the five-member hearing board) administers the sales and use tax.[7] Be aware of issues involving sales tax (applicable to sale of goods) and use tax (applicable to the storage, use, or other consumption of products that you buy out of state and bring into California).

10. Property taxes. Collected by local city and county tax collectors, California property tax includes real and personal taxes. The property tax system includes Proposition 13, which generally uses a base year and allows reassessment when there is a change in ownership. Stay vigilant, as these taxes are more enforced than they used to be.

Additional points everyone should know about California taxes follow.

B. Statute of Limitations Dances

The fact that California's basic income tax statute of limitations is four years can create problems as well as planning opportunities. As I noted in my first "Trench Notes,"[8] California's FTB often comes along after the IRS to ask for its piece of a deficiency. Moreover, whether California gets notice of the adjustment from the IRS or not, California taxpayers have an obligation to notify the FTB and pay up.[9]

Failure to notify the state is serious — the California statute of limitations never runs if you fail to do so.[10] But given California's aggressive tax enforcement, the order will often be reversed. So what happens if your audit route works in reverse order? Suppose — as commonly occurs — you have a California tax audit first, and by the time it is resolved, the federal statute of limitations has run?

With the federal statute closed, the answer happily should be nothing. Frequently, California tax advisers count on that result. Because the California statute is four years instead of three, it is possible (although unlikely as a practical matter) that California may initiate its audit after the federal statute is already closed. More likely, if the California audit has been initiated one to two years after a return filing, there may be only one or two years left on the three-year federal statute.

Even without trying to cause a delay, the California audit and ensuing administrative appeals may not be resolved until after the federal statute has run. If delays are desirable, they can often be accomplished with little effort. If it is advantageous to protract California's consideration of the case, one can almost ensure that the federal statute will have run when the California adjustment or deficiency is finalized. In general, California will notify the IRS of the adjustment and its conclusion of the case. By then it will be too late for the IRS to say, "Me, too."

C. Conformity Foibles

In the category of oddities that few will care about, beware the usual and sometimes inexplicable lack of parity between California and federal law. There is just enough conformity in California to make most federal tax practitioners comfortable that the law will be the same most of the time. But there are many, many times when that will not be true.

Cynics might say that if a provision is a taxpayer-favorable relief provision, California will not adopt it. Conversely, federal revenue raisers are often adopted quickly by the state. Yet even that rule is not always helpful. California tax practitioners often have examples of strange or even bizarre ways in which state law is different. A few examples follow.

1. Qualified settlement funds. Under federal law, a qualified settlement fund under section 468B pays tax only on its net income. Those funds are litigation settlement funds that generally are in existence for a relatively short period of time. They usually have interest income against which trustee fees, counsel fees, and other administrative expenses can be deducted.

In California, however, those funds are taxed on their gross interest income. That is, they cannot claim deductions for trustee fees, counsel fees, or any other administrative expenses[11] — I don't know why.

2. Qualified small business stock. Another conformity headache relates to small business stock. Under federal law, section 1202 provides an exclusion from income for a portion of the gain from the sale of qualified small business stock (QSBS) held for more than five years. There's considerable history to the QSBS provision, and the size of the benefit has grown.

A 50 percent exclusion in 1993 grew to a whopping 75 percent exclusion in 2009. Even more generous, the exclusion grew to 100 percent for QSBS purchased after September 27, 2010, and before

[6]Calif. Revenue and Taxation Code section 19048.
[7]Calif. Revenue and Taxation Code section 7051 et seq.
[8]*See supra* note 1.
[9]Calif. Revenue and Taxation Code section 18622(a).
[10]Calif. Revenue and Taxation Code section 19060.
[11]Calif. Revenue and Taxation Code section 24693(b).

January 1, 2012, if held for more than five years.[12] Federal law even eliminates the alternative minimum tax preference for those sales.

In California, the state tax rules affecting QSBS are less generous and more difficult than the federal rules. California has its own spin on what constitutes California QSBS and its own system for how the rules should be interpreted. Under California's version of QSBS, virtually everything must be in California (including 80 percent or more of the company's assets, and even 80 percent or more of the company's payroll).[13]

As of this writing, California has not conformed to the 100 percent exclusion offered by the federal government. In fact, California never even conformed to the prior 75 percent exclusion.[14] However, an exclusion of 50 percent is nothing to sneeze at, particularly given California's high tax rates and its lack of capital gain rates (another can of worms).

Veterans of disputes with the California FTB are likely to know that they are generally far harder to resolve than those with the IRS. This is true when discussing California QSBS cases. Some say that virtually *every* QSBS claimed on a California income tax return is examined by the FTB. Indeed, the FTB seems to have a penchant for finding ways to treat the QSBS — which may be perfectly fine for federal income tax purposes — as not qualifying in California. Disputes are common.

3. S corporation built-in gain. The Small Business Jobs Act of 2010[15] provided a boon to S corporations that previously were C corporations. Normally, those S corporations are still subject to a corporate level tax — applied at the highest marginal rate — on gain recognized during the 10-year period following the S election. Section 1374 now provides that if the fifth year of an S corporation's recognition period ends before their 2011 tax year begins, then no entity-level tax is imposed on the net recognized built-in gain for the 2011 tax year.

In essence, the corporate level tax is waived for S corporations that converted from C corporation status in 2006 or before. However, as in so many other areas, California has yet to conform to that abbreviated waiting period for S corporations.

4. Net operating losses. In general, section 172 provides that net operating losses may be carried back to prior years or carried forward to future years. The ability to use NOLs thereby preserves the economic impact of a taxpayer's loss. Taxpayers normally carry back their NOLs to the two tax years before the NOL year,[16] and then carry forward any remaining NOLs for up to 20 years after the NOL year.

California suspended NOL use in 2008 and 2009. In October 2010 the state once again suspended the ability of its taxpayers to use NOLs in the 2010 and 2011 tax years.[17] For a cash-strapped state, that limitation may help the fisc, but it hurts many taxpayers' pocketbooks. And for tax professionals, it can require caution.

D. California Tax Shelters

This is an uneasy subject. Many federal tax practitioners think they know something about tax shelter penalties. We know that some clients will be pursued for participating in or promoting sham transactions and that some familiarity with the provisions is a good idea. The stakes can be high.

The American Jobs Creation Act of 2004 (2004 Jobs Act)[18] contained many provisions designed to combat abusive transactions. Among those were increased penalties related to taxpayers' failing to disclose reportable (including listed) transactions,[19] understating tax attributable to a reportable tax avoidance transaction,[20] or failing to report transactions or accounts maintained with a foreign financial entity.[21] Penalties also were increased for a material adviser's failure to comply with new information return requirements or existing regulations requiring that investor lists be maintained and provided to the IRS,[22] and for a promoter's making or furnishing false statements in connection with the organization or sale of abusive tax shelters.[23]

In general, California conforms to the federal tax shelter penalties.[24] However, the state's Revenue and Taxation Code has a far broader definition of some terms. For example, in California, a reportable transaction includes *any* transaction having the potential for tax avoidance or evasion under federal or state law. Similarly, a listed transaction includes transactions that are the same as, or similar to, transactions specified by the IRS or the FTB as tax avoidance transactions.[25]

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[12] *See* section 2011 of the Small Business Jobs Act of 2010, P.L. 111-240; section 760 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312.

[13] Calif. Revenue and Taxation Code section 18152.5(c)(2)(A).

[14] Calif. Revenue and Taxation section 18152.5(a).

[15] P.L. 111-240.

[16] Section 13 of the Worker, Homeownership, and Business Assistance Act of 2009, P.L. 111-92, allowed some taxpayers to carry back NOLs for up to five years.

[17] Calif. Revenue and Taxation Code section 17276.21.

[18] P.L. 108-357.

[19] Section 811 of the 2004 Jobs Act, adding section 6707A.

[20] Section 812 of the 2004 Jobs Act, adding section 6662A.

[21] Section 821 of the 2004 Jobs Act, amending 31 U.S.C. section 5321(a)(5).

[22] Section 815 of the 2004 Jobs Act, amending sections 6111 and 6112.

[23] Section 818 of the 2004 Jobs Act, amending section 6700.

[24] *See* Calif. Revenue and Taxation Code sections 18407, 18628, and 18648.

[25] Calif. Revenue and Taxation Code section 18407.

Interestingly, California's penalties for abusive tax shelters and transactions apply to all open tax years. In essence, under California law, the tax shelter penalties can have a retroactive effect and apply to any tax year for which a limitations period for issuing a deficiency notice is open. For taxpayers and tax advisers who may be occasionally confronted with those issues, the differences between federal and California law are palpable.

E. California's Proposition 13

Rightly or wrongly, California has often led the way. In the property tax field, California was first to roll back escalating property taxes. In 1978 Proposition 13, the People's Initiative to Limit Property Taxation, amended the California Constitution. Approved by California voters on June 6, 1978, it was declared constitutional by the U.S. Supreme Court in *Nordlinger v. Hahn*.[26]

Proposition 13 limits the tax rate for real estate by providing that the maximum amount of any ad valorem tax on real property shall not exceed 1 percent of the full cash value of that property. It decreased property taxes by assessing property values at their 1975 value and restricting annual increases of assessed value to an inflation factor not to exceed 2 percent per year. It also prohibited reassessment of a new base-year value except for changes in ownership or completion of new construction.

The change in ownership concept has become paramount. The limit provided by Proposition 13 does *not* apply when a change in ownership occurs or new construction is completed. At that time, California can reappraise the property at its full cash value and impose property taxes based on the current value of the property or new construction. In general, for purposes of Proposition 13, a change in ownership means a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest.[27]

Many commercial real estate owners have been able to sell or merge entities in a way that effects a practical change of ownership without triggering a Proposition 13 reassessment. Many characterize that feature of Proposition 13 as fundamentally unfair, a shifting of the property tax burden away from commercial properties and toward private homeowners and consumers who cannot conduct their affairs that way.[28] Some think commercial property owners are getting unfair advantages in California.

F. Amazon Laws

No report from the California tax trenches would be complete without a line about the recently imposed "Amazon" law. On June 29 Gov. Jerry Brown (D) signed ABX1 28, which expands the scope of sales and use tax imposed by the Revenue and Taxation Code by establishing a nexus for taxing some Internet merchants.[29]

Under newly amended section 6203 of the California Revenue and Taxation Code, an out-of-state retailer has substantial nexus with California (and can be taxed) when it enters into agreements under which a California merchant (for a commission or other consideration) refers potential purchasers to it via an Internet-based link or a website. On passage of the law, Amazon promptly cut its ties with California merchants who create the requisite nexus.[30] Court challenges are expected.

In the wake of that law, Amazon already plans to ask California voters to address the new tax. Amazon wants to use California's odd, take-it-to-the-voter system to overturn the new law, which requires many previously untouchable companies to collect sales tax from customers. First, to get the anti-Amazon tax measure on the ballot, a referendum petition must be signed by at least 5 percent of the voters in the previous gubernatorial election. Under that rule, Amazon would need to collect approximately 504,760 signatures. California's secretary of state randomly verifies some of the signatures, and the referendum then goes on the ballot. It will be an interesting debate with various legal nuances to watch.

The latest skirmish will certainly add to the problems facing tax lawyers practicing in California. Indeed, the Amazon law may hurt California's small businesses, which have lost a valuable marketing resource.

G. Conclusion

California's tax system is complex and nuanced. All else being equal, I believe most tax practitioners in California would rather face federal than state tax problems — it is almost always easier to settle a federal tax dispute than a California one.

Yet for all its idiosyncrasies, California's tax system offers opportunities as well as problems. Enjoy them!

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[26]505 U.S. 1 (1992).

[27]Calif. Revenue and Taxation Code section 60.

[28]*See* Jennifer Bestor of Menlo Park, Calif., in her open letter to Warren Buffet, *available at* http://caltaxreform.org/?p=253.

[29]*See* Karen Setze, "California Governor Signs 'Amazon' Law," *State Tax Notes*, July 4, 2011, p. 7, *Doc 2011-14280*, or *2011 STT 126-2*.

[30]*See* http://www.boe.ca.gov/members/runner/newsreleases/Amazon_Letter_to_Senator_Runner.pdf.