CALIFORNIA CHAMBER OF COMMERCE

ALERT

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Analysis

Business Tax Bill Higher in State Budget Plan

California businesses and investors will be paying $5.8 billion more in taxes in 2008–09 and $1.6 billion more in 2009–10, due to the newly adopted state budget.

Following is a brief analysis of key tax provisions in the budget agreement. The Legislature finessed a "tax increase" by accelerating and borrowing substantial revenues (interest-free) from California businesses for a minimum of the next two tax years. Some offsetting reforms were adopted, but many companies investing in jobs and operations in California—or attempting to emerge from losses in the economic downturn—will suffer higher tax bills.

The California Chamber of Commerce recommends that businesses consult with your tax professionals on how the new tax requirements affect your own business.

Penalty for Reasonable Disputes

An 11th-hour addition to the budget package (added after the Governor threatened to veto an acceleration of personal income tax withholding), is a new, permanent and unprecedented 20 percent penalty on what is being characterized as "underpayments" of taxes of $1 million or more that exist after May 2009. Estimated to raise $1.5 billion in 2009, the penalty would be applied to tax years beginning January 1, 2003. The penalty is in addition to existing penalties.

Analysis: The penalty will apply when the taxpayer reports less than the Franchise Tax Board (FTB) thinks the taxpayer owes. FTB will have wide latitude and discretion to impose the penalty because, unlike most existing state and federal penalties, the new penalty has no "reasonable cause" exception, making it applicable to even reasonable tax payer behavior. Due to the complexity of the tax laws, companies may have a series of reasonable disputes with the state over tax issues totaling $1 million or more, which normally get resolved over time. Similar to a problematic penalty scheme in a tax "amnesty" program the state conducted in 2005, this new penalty provision will force companies to overpay their taxes by May 2009 to include amounts reasonably in dispute, in order to ensure they incur no 20 percent penalty if the dispute is decided against them. If the dispute is decided in the company's favor, it will eventually receive a refund, but in the meantime, the state has received an interest-free loan.

The only instances in which the penalty does not apply is if the underpayment is due to a change in law or reliance on advice by the FTB.

Tax Credits Limit

The budget agreement placed a two-year limit on the ability of businesses to use most business tax credits, capping those credits at one-half of the taxpayer's tax liability (an estimated $900 million increase). Effective January 2010, tax credits may be shared among a related group of affiliate or subsidiary companies, unitary utilization.

Analysis: This tax credit limitation affects California's only remaining statewide investment incentive tax credits, for tax years January 1, 2008 to January 1, 2010, including the research and development, enterprise zone and manufacturing equipment credits. The limitation in effect increases taxes for companies currently relying upon these credits. The research and development credit has played a major role in keeping California on the leading edge of innovation, and the enterprise zone program has served as an important tool for economically distressed localities to retain and attract jobs and manufacturing operations. Credits that could have been used during the two-year limitation period are permitted to be carried over, but the lost time-value to companies is permanent.

Small businesses with net incomes of less than $500,000 are exempt from the tax credit limitation.

The clarification in the law permitting companies to elect unitary utilization will help those needing the flexibility to allocate earned tax credits within their family of companies. FTB must report to the Legislature before June 30, 2013, the usage and effects of unitary utilization.

Net Operating Loss

The budget agreement suspended for two years a business' ability to deduct net operating losses (NOL). After the two-year suspension period, treatment of losses would fully conform to federal law as to how such losses may be carried back and carried over. (Suspension estimated to raise $1.1 billion in first year; $600 million in second.)

Analysis: The suspension for the 2008 and 2009 tax years affects both personal and corporate income taxes. The NOL deduction gives businesses more flexibility to manage losses by allowing them to offset or deduct one tax year's losses from another tax year's profits. The purpose is to resolve an inequity in our tax structure—which comes from businesses experiencing losses or profits according to timeframes or cycles over time that differ from the arbitrary and rigid government tax filing deadlines. The two-year suspension may cause marginally profitable businesses greater difficulty in emerging from losses, due to greater tax liability and reduced cash flow.

Small businesses with net income of less than $500,000 are exempted from the NOL suspension.

The conformity with federal law to allow two-year carryback is phased in beginning January 1, 2011 and the 20-year carryover applies to losses incurred after January 1, 2008. Current California law provides for no carryback and only a 10-year carryover. Carryback and expanded carryover will provide added flexibility for companies that use the NOL deduction.

Accelerated Tax Payments

Beginning January 1, 2009, personal income tax and corporate tax filers must pay more of their estimated taxes earlier in the year (an estimated $2.3 billion increase).

Analysis: Tax payments increase for all individual and corporate filers in the fourth and sixth months of the tax year from 25 percent to 30 percent. In the ninth and 12th months of the tax year, the tax rate decreases from 25 percent to 20 percent.

Individual filers of quarterly estimates with gross income the previous year of more than $1 million will see their safe harbor eliminated. This will affect small businesses, many of which file under personal income tax laws.

Limited Liability Companies

Limited liability companies (LLC) must pay their annual fees during the first six months of the current tax year (an estimated $360 million increase).

A 10 percent penalty will be assessed for underpaying the accelerated fee.

Previously, a current year's LLC fee was due in the following tax year. The new fee deadline will result in a double payment in the early part of 2009—both the prior year's LLC fee and the current year's. This may be especially hard on small companies that have limited cash flow.

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