California updates federal tax conformity to January 1, 2015

Overview

On September 30, 2015, Governor Jerry Brown signed into law Assembly Bill 154 (A.B. 154),[1] which includes the following modifications to California law:

- Advances California's federal tax conformity to the Internal Revenue Code (IRC) as of January 1, 2015
- Resolves ambiguities surrounding the validity of Senate Bill 401 (S.B. 401)
- Provides additional exceptions to the 20 percent large corporate understatement penalty
- Conforms to federal net operating loss carryback procedure allowing an extension of the time to pay tax
- Conforms to federal limits on compensation deductions for covered health insurance providers
- Conforms to federal denial of deduction for annual fee on branded prescription pharmaceutical manufacturers and importers
- Conforms to various other changes made to the IRC between 2009 and 2015

This Tax Alert summarizes these law changes, which are effective immediately and operative for taxable years beginning on or after January 1, 2015.

Updates IRC conformity

A.B. 154 advances California's federal tax conformity date to the IRC as enacted on January 1, 2015, which applies to taxable years beginning on or after January 1, 2015.[2] Prior to this bill, California conformed to the IRC as of January 1, 2009, for taxable years beginning on or after January 1, 2010.[3]

Resolution of ambiguities created by S.B. 401

A.B. 154 explicitly states that "[i]t is the intent of the Legislature to confirm the validity and ongoing effect of [S.B. 401.]"[4] Given this confirmation that S.B. 401 is valid, ambiguities concerning which version of the IRC applied to taxable years 2010 through 2013 and the validity of other changes made by S.B. 401 appear to be resolved.[5]

Specifically, A.B. 154 codifies California's conformity to the IRC as of January 1, 2009, for taxable years beginning on or after January 1, 2010, and on or before December 31, 2014.[6] This is especially important for taxpayers that had undertaken transactions governed by IRC § 355, such as spin-offs, during or after 2010. Prior to A.B. 154, it was uncertain whether S.B. 401 was valid. If S.B. 401 were invalid, California would conform to the version of IRC § 355 in effect on January 1, 2005—which did not include the statutory amendment enacted on May 17, 2006, that added IRC § 355(b)(3) and liberalized the "active trade or business" requirement.[7] If the pre-2005 version of the IRC were to apply, a stricter "active trade or business" requirement would apply to transactions governed by IRC § 355. A.B. 154 confirms that taxpayers that engaged in IRC § 355 transactions during or after 2010 will not lose tax-free treatment applicable under the amended version of the statute.

SB. 401 also excluded from gross income and alternative minimum taxable income for California purposes any grant made by the federal Secretary of Treasury under Section 1603 of the American Recovery and Reinvestment

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[1] Laws 2015, ch. 349, 2015-2016 Regular Session (A.B. 154). A copy of the adopted law is accessible here.
[2] A.B. 154, Sec. 1, amending Cal. Rev. & Tax Code § 17024.5.
[3] Cal. Rev. & Tax Code § 17024.5(a)(1)(O).
[4] A.B. 154, Sec. 42.
[5] California's prior conformity provisions were passed on April 12, 2010 as a part of S.B. 401. Subsequent to the passage of S.B. 401, California voters on November 2, 2010 passed Proposition 26 (Prop 26). Prop. 26 required that a change in state law that results in *any* taxpayer paying a higher tax must be passed by a two-third's supermajority vote in both Houses of the California Legislature. Prop. 26 also provided that any legislation that results in a tax increase that was passed from January 1, 2010 through November 2, 2010, without meeting the supermajority requirement is void unless the legislation is re-enacted by the requisite two-thirds vote by November 3, 2011. Because S.B. 401 was passed by only a majority vote and the Legislature did not re-enact it by a supermajority vote by the deadline, questions arose as to whether the changes made by SB. 401 applied, even though the Franchise Tax Board issued Legal Division Guidance 2011-01-01 confirming its intent to treat S.B. 401 as valid law until an appellate court determined otherwise.
[6] A.B. 154, Sec. 1, amending Cal. Rev. & Tax Code § 17024.5.
[7] *See* Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 348.

Act of 2009 (Public Law 111-5) (ARRA) that applies to certain renewable energy property placed in service in 2009 or 2010, or after 2010 if construction began on the property during 2009 or 2010.[8] A.B. 154 confirms that this exclusion applies for taxpayers who received federal renewable energy grants under Section 1603 of the ARRA.

Additional exceptions to 20 percent large corporate understatement penalty

California generally imposes the Large Corporate Understatement Penalty (LCUP) for understatements of tax in excess of $1 million as reflected on an original return (or an amended return filed on or before the original or extended due date for the return).[9] The penalty is 20 percent of the understatement of tax.[10] The law applicable prior to the adoption of A.B. 154 provided the following exceptions—the penalty does not apply to understatements of tax attributable to: (1) a change in law, a regulation, a legal ruling of counsel, or a published federal or California court decision occurring after the earlier of the date the return is filed or the extended due date for the year that the change is operative; or (2) reasonable reliance on a formal Franchise Tax Board (FTB) Chief Counsel Ruling.[11] A.B. 154 provides the following additional exceptions to the LCUP penalty:

- An increase in tax resulting from a proper IRC section 338 election (relating to certain stock purchases treated as asset acquisitions) as reported on the first amended return shall be treated as if that amount was included in the tax as shown on the original return.[12]
- No penalty shall be imposed if the understatement results from:
  - The FTB's imposition of an alternative apportionment or allocation method under the authority of Cal. Rev. & Tax Code section 25137 because the standard formula does not fairly represent the extent of the taxpayer's business in California.[13]
  - A change to the taxpayer's federal accounting method under IRC section 446 (relating to the general rule for methods of accounting), but only to the extent of understatements for taxable years where the due date for the return, without regard to any extension of time for filing the return, is before the date the Secretary of the Treasury consents to the change.[14]

Notably, the FTB has frequently used Cal. Rev. & Tax Code section 25137 to wholly or partially include or exclude certain types of receipts from a taxpayer's sales factor on the basis that inclusion or exclusion was distortive. Because the FTB has discretion to apply that provision after the taxpayer has already filed its return, taxpayers had no way of knowing if they would later be subject to the LCUP. A.B. 154 provides taxpayers some relief from the FTB's application of that provision, and the new exception applies to understatements for any taxable year for which the statute of limitations on assessments has not expired as of the effective date of A.B 154.[15]

Modified conformity to federal net operating loss carryback procedure

Federal income tax laws allow a corporation that expects a net operating loss (NOL) in the current year to file a statement with the Secretary of the Treasury to extend (e.g., postpone) the time to pay the tax for the immediately preceding tax year.[16] California's current NOL carryback provisions require NOLs generated in a taxable year beginning on or after January 1, 2013, to be carried back two preceding taxable years.[17] A.B. 154 conforms California to the federal provision, which allows this tax payment extension.[18]

Conformity to federal limits on compensation deductions for covered health insurance providers

Federal income tax laws provide a $500,000 limit on compensation deductions for covered health insurance providers for tax years beginning on or after January 1, 2013.[19] A.B. 154 conforms California to this federal provision.

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[8] S.B. 401 also conformed California law to the basis adjustment and recapture requirements to which such renewable energy properties are subject for federal purposes.
[9] Cal. Rev. & Tax Code § 19138(a).
[10] Cal. Rev. & Tax Code § 19138(b).
[11] *See* Cal. Rev. & Tax Code § 19138(f)-(g); FTB Large Corporate Understatement Penalty FAQs.
[12] A.B. 154, Sec. 20, amending Cal. Rev. & Tax Code § 19138(b).
[13] A.B. 154, Sec. 20, amending Cal. Rev. & Tax Code § 19138(f).
[14] *Id.*
[15] A.B. 154, Sec. 20, amending Cal. Rev. & Tax Code § 19138. The California Legislature stated that it "finds and declares that the application of [this provision] to taxable years for which the statute of limitations on assessments has not expired as of the effective date of this act serves a public purpose by ensuring fair and consistent application of California law in cases where the [FTB] imposes on a taxpayer an alternative allocation or apportionment method under the authority of Section 25137." A.B. 154, Sec. 43.
[16] I.R.C. § 6164.
[17] Cal. Rev. & Tax Code § 24416.22.
[18] A.B. 154, Sec. 19, adding Cal. Rev. & Tax Code § 19131.5.
[19] I.R.C. § 162(m)(6).

Conformity to denial of deduction for annual fee on branded prescription pharmaceutical manufacturers and importers

Section 9008 of the Patient Protection and Affordable Care Act ("ACA") imposed an annual fee (treated as an excise tax) on entities in the business of manufacturing or importing branded prescription drugs for sale to any specified government program or pursuant to coverage under any such program. The fees imposed are not deductible for federal income tax purposes.[20] California did not previously conform to IRC § 275. Rather, Cal. Rev. & Tax Code contains its own provision regarding the deductibility of taxes under Section 24345, which makes no reference to the drug fee and its deductibility. A.B. 154 conforms with federal law to specify that this annual fee would not be deductible for California income tax purposes.[21]

Other areas of conformity and disconformity

Several changes to the IRC were made between 2009 and 2015. As a result of A.B. 154, California conforms to some of those changes. For details regarding the IRC provisions to which California now conforms, taxpayers may refer to the FTB's Final Bill Analysis[22] and the various legislative analyses[23] for A.B. 154.

ASC 740 treatment

Pursuant to ASC 740, "Income Taxes," companies are required to account for the effect of a change in income tax law in the period that includes the enactment date of that law change. As noted previously, A.B. 154 was enacted on September 30, 2015. Accordingly, the enactment of A.B. 154 is a third quarter event for financial statement purposes for calendar year taxpayers.

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[20] *See* Section 9008(f) of the ACA, which characterizes the fee as a nondeductible tax under I.R.C. § 275.
[21] AB 154, Sec. 13, adding Cal. Rev. & Tax Code § 17240, which provides that "the fee imposed by Section 9008 of the [ACA] shall be considered a tax described in Section 275(a)(6) of the [IRC]." IRC § 275(a)(6) provides a list of specific taxes for which no deduction is permitted for federal income tax purposes.
[22] FTB Bill Analysis, A.B. 154, *available at:* https://www.ftb.ca.gov/law/legis/15_16bills/ab154_Final.pdf.
[23] Legislative Analyses, A.B. 154, *available at:* http://www.legislature.ca.gov/cgi-bin/port-postquery?bill_number=ab_154&sess=CUR&house=B&author=ting_<ting>.