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# Inside Deloitte California report: Is all quiet on the legislative front?

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# California Report: Is All Quiet on the Legislative Front?

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In this article, the authors summarize various pending tax-related legislative proposals in California, and they provide taxpayer considerations regarding the potential effect of each proposal if enacted.


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Legislatively, things seem fairly quiet in California of late. Taxpayers seem to have settled into the new normal since the whirlwind of regime changes in the first half of the decade, including a significant corporate franchise tax overhaul that enacted factor presence nexus;[1] mandatory single-sales-factor apportionment;[2] market-based sourcing for sales of services and intangibles;[3] a strict liability penalty on understatements of tax;[4] the elimination of the long-running enterprise zone credit;[5] the California Competes credit;[6] a temporary sales tax increase;[7] a new specialized manufacturing use tax exemption;[8] and a temporary personal income tax increase.[9]

Indeed, the corporate franchise tax provisions, except for the aforementioned penalty, have become the norm across a number of jurisdictions. Uniquely for California, however, many of these changes came to be via voter ballot propositions. Ironically, the voters have both strengthened California's constitutional requirements for a two-thirds vote by each house of the State Legislature for a tax increase, thus making it more difficult to raise taxes, and provided the votes necessary to enact many of the provisions listed above. Although voters have been mobilized to make big things happen, arguably more mundane legislative efforts, such as periodically updating the date of California's conformity to the Internal Revenue Code, can sometimes take a back seat.

Specifically, regarding the two-thirds vote requirement, the passage of Proposition 26 in November 2010 expanded the definition of the terms "tax" and "tax increase" so that more proposals regarding taxes would require a two-thirds vote of the California State Legislature or approval from local voters.[10] Although the 2012 and 2014 election cycles changed the number of Republicans and Democrats in the California State Senate and State Assembly, neither party has the two-thirds supermajority necessary to unilaterally enact new tax legislation.[11] Accordingly, it remains difficult to pass new tax law in California.

Nevertheless, interesting legislative tax proposals and related matters are afoot in the Golden State. With the 2015-2016 legislative session underway, the primary pending developments to watch include:

- an update to California's conformity to the IRC;
- an update to California's large corporate understatement penalty (LCUP);
- California's response to the federal mobile workforce bill;
- proposals seeking to increase California's tax revenue; and
- tax-related changes to California's Health and Safety Code.

This article summarizes these and other significant proposals and their related background, as well as potential implications for taxpayers if some or all of the pending measures become law.

[1]Cal. Rev. & Tax. Code section 23101(b).
[2]Cal. Rev. & Tax. Code section 25128.7.
[3]Cal. Rev. & Tax. Code section 25136.
[4]Cal. Rev. & Tax. Code section 19138.
[5]Cal. Rev. & Tax. Code sections 17053.70, 17053.74, and 17053.75.
[6]Cal. Rev. & Tax. Code sections 17059.2, 18410.2, and 23689.
[7]Cal. Const. Art. XIII, section 36(f)(1)(A).
[8]Cal. Rev. & Tax. Code section 6377.1.
[9]Cal. Const. Art. XIII, section 36(f)(2).

[10]Proposition 26, sections 2 (amending Cal. Const. Art. XIII A, section 3 to add subsection (d)) and 3 (amending Cal. Const. Art. XIII C, section 1 to add subsection (e)). (In other words, Proposition 26 strengthened the 1978 proposition known as Proposition 13.)
[11]*See* California elections, Ballotpedia (2012).

## I. IRC Conformity

Unlike those in most other states, California's tax laws do not reference or incorporate federal taxable income as a starting point for determining California taxable income. Instead, California tax laws comprise a combination of California-only provisions and IRC provisions selectively incorporated by reference, without modification unless specifically stated otherwise. For specific tax years, California conforms to the IRC as of a particular date;[12] this conformity date is not updated automatically, but rather legislation is required — via either individual tax bills or omnibus bills — to update the state's conformity. As such, there is a lapse between the date on which an addition or modification is made to the IRC and the date on which that addition or modification is incorporated for California tax law purposes.

Our first group of legislative developments includes proposed legislation to update California's conformity with the IRC and proposed legislation seeking to conform California tax law to the federal alternative simplified credit.

### A. AB 154 Would Address 3 Conformity Issues

#### *1. Advances conformity date 6 years*

California Revenue and Taxation Code (CRTC) section 17024.5(a)(1)(O) provides that for tax years beginning on or after January 1, 2010, California conforms to the IRC as of January 1, 2009. AB 154, introduced in the California Assembly on January 16, 2015, would update the CRTC conformity date to January 1, 2015, for tax years beginning on or after January 1, 2015.[13]

AB 154 was introduced as an urgency statute, which means that the provisions in the measure would take effect immediately upon its passage. Since AB 154 includes clauses that would increase tax on some California taxpayers, section 3 of Article XIII A of the California Constitution, as amended by Proposition 26, requires a two-thirds vote from each house of the state Legislature for the measure to pass. On June 3, 2015, AB 154 was passed 75 to 0 on the Assembly floor[14] and forwarded to the Senate. On August 31, an amended version of AB 154 was passed 39 to 0 on the Senate floor and returned to the Assembly for concurrence on the Senate amendments.[15] Assuming the Assembly concurs with the Senate amendments, the legislation will be sent to the governor for signature.

AB 154 would be California's first conformity update since SB 401 was passed on April 12, 2010, bringing California into conformity with the IRC as of January 1, 2009, for tax years beginning on or after January 1, 2010. However, there remains uncertainty regarding the validity of SB 401 because of the passage in November 2010 of Proposition 26, which, as noted above, imposed a two-thirds supermajority requirement for tax increases.[16] As discussed immediately below, AB 154 would resolve this ambiguity.

#### *2. Seeks to resolve ongoing ambiguity over SB 401's validity*

The Franchise Tax Board discusses this ambiguity in Legal Division Guidance 2011-01-01, commenting that SB 401 is valid for the 12-month period following the passage of Proposition 26. However, it says that uncertainty exists after November 3, 2011 (the expiration of the 12-month period), because SB 401 was never reenacted by the state.[17] The guidance also says that it is uncertain whether SB 401 would have to be reenacted in its entirety or whether only the tax-increasing provisions of SB 401 would have to be reenacted.[18]

Ultimately, the FTB concludes that SB 401 is valid until an appellate court determines that some or all of it is void under Proposition 26.[19] This is because section 3.5 of Article III prohibits an administrative agency from declaring a statute unenforceable or invalid in the absence of a decision from an appellate court stating that it is unenforceable or invalid.

AB 154 attempts to eliminate this ambiguity by stating in an uncodified provision of the bill that "it is the intent of the Legislature to confirm the validity and ongoing effect of Senate Bill No. 401 of the 2009-10 Regular Session."[20] If passed, AB 154 could be important to taxpayers who have taken the position that SB 401 is invalid and accordingly filed returns under California conformity to the IRC as of January 1, 2005, which may have resulted in an understatement of tax and a potential exposure to penalties, including the LCUP, discussed below.

#### *3. Select conformity to some tax-related provisions of the Affordable Care Act*

In addition to the proposed update to the IRC conformity date, AB 154 would address California's conformity with other previously unincorporated sections of the IRC. One significant addition to the IRC since January 1, 2009,

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[12]Cal. Rev. & Tax. Code sections 23051.5 and 17024.5.

[13]All references to AB 154 are to the version of the bill as amended on June 30, 2015.

[14]*See* the unofficial ballot for AB 154, *available at* http://leginfo.legislature.ca.gov/faces/.billVotesClient.xhtml?bill_id=201520160AB154.

[15]*See* the history for AB 154, *available at* http://leginfo.legislature.ca.gov/faces/billHistoryClient.xhtml?bill_id=201520160AB154.

[16]Also under Proposition 26, any measure adopted between January 1, 2010, and November 3, 2010, without a two-thirds majority vote would be void on November 3, 2011, unless reenacted by the Legislature and passed with a two-thirds vote. SB 401 was passed between January 1, 2010, and November 3, 2010, by a simple majority. Because SB 401 includes provisions that increase taxes, it should have been reintroduced in the Legislature. Because SB 401 was never reintroduced, there are questions regarding its validity.

[17]Cal. FTB Legal Div. Guidance 2011-01-01.

[18]*Id.*

[19]*Id.*

[20]AB 154, section 42.

is the Patient Protection and Affordable Care Act.[21] AB 154 would specifically modify California's conformity to three provisions of the ACA.

Section 9004 of the ACA amended IRC sections 220(f)(4)(A) and 223(f)(4)(A) to increase the additional tax on distributions from Archer medical savings accounts (MSAs) and health savings accounts not used for qualified medical expenses. California does not conform to IRC section 223 regarding HSAs, and this would remain unchanged by AB 154.[22] California generally conforms to IRC section 220 regarding Archer MSAs but imposes the additional tax on distributions not used for qualified medical expenses at a rate of 10 percent, as compared with 20 percent for federal income tax purposes under the ACA.[23] If AB 154 becomes law, it will increase California's tax on those distributions from Archer MSAs from 10 percent to 12.5 percent.[24]

Section 9008 of the ACA imposed a new annual fee on some branded prescription pharmaceutical manufacturers and importers. AB 154 would specify that this annual fee would not be deductible for California income tax purposes.[25]

Section 9013 of the ACA amended the itemized deduction for medical expenses allowed under IRC section 213(a) to provide that it was permitted only to the extent that those expenses exceed 10 percent of adjusted gross income. Previously, the deduction was permitted to the extent that those medical expenses exceeded 7.5 percent of AGI.[26] Under AB 154, California would continue to permit the itemized deduction for medical expenses to the extent that they exceed 7.5 percent of the taxpayer's AGI, rather than conforming to the 10 percent threshold that now applies for federal income tax purposes.[27]

### B. AB 544 Proposes Conformity to the Federal Alternative Simplified Credit

While the largest overhaul of California's conformity with the IRC is addressed by AB 154, the Legislature has also introduced other measures that would address the conformity issue. AB 544 was introduced February 23, 2015, seeking to update California law to conform to the Alternative Simplified Credit (ASC).[28]

The ASC is an alternative, elective method to calculate the federal research and development tax credit. The ASC is equal to 14 percent of the taxpayer's current-year qualified research expenditures that exceed 50 percent of the taxpayer's average qualified research expenditures for the three prior tax years.[29] Taxpayers that elect to use the ASC cannot revoke their election without the IRS's consent.[30] The IRS finalized regulations in February 2015 allowing taxpayers to elect the ASC on amended federal returns for which the statute of limitations has not expired.[31]

The ASC differs from the traditional and start-up methods of calculating the R&D credit, which both provide a 20 percent credit for any qualified research expenditures that exceed a calculated base amount.[32] Although these methods provide a greater credit to taxpayers, they are harder to qualify for because they require higher amounts of qualified research expenditures, involve more substantive record keeping, and are limited by increasing gross receipts.[33]

If AB 544 is passed, California taxpayers will be able to compute their version of the R&D tax credit under the ASC for tax years beginning on or after January 1, 2016, and before January 1, 2021.[34] This calculation would mirror the federal ASC computation, with one primary change that would reduce the credit available to taxpayers from 14 percent to 7 percent.[35] As of May 28, 2015, AB 544 has been held under submission in the Assembly Appropriations Committee.

If the general conformity provisions in AB 154 are enacted, California will conform to IRC section 41 as of January 1, 2015, subject to the various modifications set forth in CRTC sections 17052.12 and 23609, which would include the ASC. However, AB 154 does not contain the provisions in AB 544 that reduce the available credit from 14 percent to 7 percent. Also, AB 154 would be effective January 1, 2015, whereas AB 544 would be effective for tax years beginning on or after January 1, 2016.[36]

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[21]P.L. 111-148 (124 Stat. 119 (2010)).

[22]Cal. Rev. & Tax. Code section 17215.4.

[23]Cal. Rev. & Tax. Code section 17215.

[24]AB 154, section 12 (proposing to amend Cal. Rev. & Tax. Code section 17215).

[25]AB 154, section 13 (proposing to add Cal. Rev. & Tax. Code section 17240), which would provide 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 section 275(a)(6) provides a list of specific taxes for which no deduction is permitted for federal income tax purposes.

[26]P.L. 111-148 (124 Stat. 119 (2010), section 9013.

[27]AB 154, section 14 (proposing to add Cal. Rev. & Tax. Code section 17241).

[28]26 IRC section 41(c) (added to the IRC on June 10, 2011).

[29]26 IRC section 41(c)(5)(A).

[30]26 IRC section 41(c)(5)(C).

[31]Treas. reg. section 1.41-9(b)(2) (as amended in 2015); taxpayers may not make an ASC election for a particular year if the taxpayer or any member of the taxpayer's controlled group previously claimed an IRC section 41 credit for that year. *Id.*

[32]26 IRC section 41(c)(4)(A)-(B).

[33]*Id.*

[34]AB 544, sections 1 and 2 (amending Cal. Rev. & Tax. Code sections 17052.12(g)(2)(A) and 23609(h)(2)(A)).

[35]*Id.*

[36]AB 154, section 1 (proposing to amend Cal. Rev. & Tax. Code section 17024.5(a)(1)(P)); AB 544, section 1 (proposing to amend Cal. Rev. and Tax. Code section 17052.12(g)(2)(A)).

## II. California Seeks to Amend Large Corporate Understatement Penalty

In addition to updating California's conformity to the IRC, AB 154 also seeks to amend the LCUP, imposed under CRTC section 19138. The LCUP is a 20 percent strict liability penalty imposed on corporate taxpayers with an understatement that exceeds the greater of $1 million or 20 percent of the tax shown on an original return.[37] AB 154 would amend the LCUP to include carveouts for underpayments resulting from proper IRC section 338 elections, the imposition of an alternate apportionment or allocation method by the FTB, and a change in the taxpayer's federal accounting method.

The first of these proposed amendments would provide that any understatement of tax shown on an amended return resulting from a proper IRC section 338 election would not be considered an underpayment of tax for purposes of the LCUP.[38] Instead, the understated amount would be considered to have been reported on the originally filed return.[39] As such, the amount of understated tax would not be subject to the LCUP.

The second proposed amendment states that the LCUP would not apply when the understatement of tax results from the FTB's imposition of an alternative apportionment or allocation method on the taxpayer under the authority of CRTC section 25137.[40] In general, the FTB is authorized to require a taxpayer to use an alternative apportionment method under CRTC section 25137 when the general apportionment formula "[does] not fairly represent the extent of a taxpayer's business in the state." AB 154 would also provide that the "Legislature finds and declares that" the amendment to exclude from the LCUP an understatement resulting from an alternative apportionment method for "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."[41]

The final proposed amendment would exempt from the LCUP understatements of tax resulting from a change in the taxpayer's federal accounting method.[42] However, the due date of the relevant return must occur before the date on which the secretary consents to change the accounting method.[43] This means that understatements of tax reported on tax returns due after the change in accounting method would be subject to the LCUP.

[37]Cal. Rev. & Tax. Code section 19138(a)(1).

[38]AB 154, section 20 (proposing to amend Cal. Rev. & Tax. Code section 19138(b)(3)).

[39]*Id.*

[40]AB 154, section 20 (proposing to amend Cal. Rev. & Tax. Code section 19138(f)(2)).

[41]AB 154, section 43.

[42]AB 154, section 20 (proposing to amend Cal. Rev. & Tax. Code section 19138(f)(3)).

[43]*Id.*

## III. Tax Exemptions for Nonresidents Working in State For a Limited Number of Days

Outside conformity and amendment of the LCUP, the Legislature has been considering SB 500, which would provide a de minimis safe harbor from California income tax for nonresident individuals working in the state. SB 500 was introduced in response to the federal government's increasing interest in passing a mobile workforce law that would create a uniform set of rules limiting the states' ability to impose income tax on nonresident individuals who are required to comply with filing obligations based on a differing set of laws in each state where they work.

### A. Federal Attempts to Limit a State's Ability To Tax Nonresidents

The lack of state uniformity in this area has led the federal government to consider legislation that would limit a state's ability to impose income tax on nonresidents. In 2013 the Mobile Workforce State Income Tax Simplification Act was introduced in Congress but not enacted.[44] The proposed law would have required state income tax and withholding on employee income only if an employee spent more than 30 days in any given state.[45] Professional athletes, professional entertainers, and public figures who receive compensation for services on a per-event basis would not have been covered by this 30-day rule.[46] In the 2015 congressional session, similar legislation — also named the Mobile Workforce State Income Tax Simplification Act — was reintroduced in the House and Senate, with the House version approved by the Judiciary Committee on June 17. However, beyond that committee action, the legislation remains pending as this article goes to press.[47]

In response to this federal action, many states, including California, are considering de minimis exceptions that would enable nonresidents to work a limited number of days in the state before imposing an income tax filing obligation on the employee and a withholding obligation on the employer.[48] These state proposals could signal to the federal government that states want to work together to address the issue of nonresident taxation in a manner that enables states to maintain autonomy in this area.

### B. SB 500 Would Accomplish Goals Similar To Those Sought in Pending Federal Legislation

SB 500 was introduced in the California Senate on February 26, 2015, in an attempt to adopt a state version of the federal mobile workforce bills under consideration by

[44]H.R. 1129 and S. 1645.

[45]H.R. 1129, section 2(a), and S. 1645, section 2(a).

[46]H.R. 1129, section 2(d)(2), and S. 1645, section 2(d)(2) (excluding "a professional athlete, professional entertainer, or certain public figures" from the definition of employee).

[47]H.R. 2315 and S. 386.

[48]Cara Griffith, "Nonresident Income Taxes — Not Just for Professional Athletes," *Forbes*, Dec. 1, 2014, *available at* http://onforb.es/1yEGP0q.

both chambers of Congress. SB 500 was based on a model statute drafted by the Multistate Tax Commission;[49] it was passed on the Senate floor on June 1 and sent to the Assembly. On August 18, 2015, SB 500 was re-referred to the Appropriations Committee after being read for a second time and amended.[50]

SB 500 would provide that nonresident individual taxpayers could exclude their California-source income from taxation if they have no other income from sources in California, work in the state for no more than 20 days per tax year, and reside in a state that provides a similar exclusion or does not impose an income tax.[51] However, the proposed law would require some nonresident employees to file an informational return with the state.[52]

Currently, California requires nonresident taxpayers to pay income taxes in the state by multiplying their California-source taxable income by an effective tax rate.[53] That rate is calculated by first computing the individual's personal income tax liability under California law as if the taxpayer were a California resident for the current tax year and for all prior tax years for any carryover items, deferred income, suspended losses, or suspended deductions. The hypothetical personal income tax liability resulting from this calculation is then divided by the taxpayer's total taxable income to arrive at an effective tax rate.[54] Because this effective tax rate is applied against any California-source income of the taxpayer, a nonresident taxpayer may be subject to California tax even if the individual works in California for a single day. Also, the nonresident taxpayer's employer must withhold expected taxes on any California-source income.[55]

Other states also generally require nonresident taxpayers to pay tax on income earned in their state and employers to withhold expected taxes on income sourced to their state. However, each state is free to dictate the income tax reporting requirements that it imposes on employees who work within its borders, as well as the withholding requirements for employers in the state. These reporting and withholding requirements could be triggered by an employee working a specific number of days in a state or by an employee earning a specific amount of income in a state.

Beyond the taxpayer income exclusion contemplated in SB 500, the pending bill would also address the withholding requirements for employers on the excluded income.[56] An employer would be subject to a penalty for erroneously applying SB 500 and failing to withhold income taxes unless it made its determination based on a time management system that requires employees to record their location daily and the employer to use this information to allocate the employees' wages between tax jurisdictions.[57] The penalty also would not apply if the employer required the employees to maintain a travel log.[58]

Like the federal workforce bills under consideration, SB 500 would not apply to professional athletes, professional entertainers, and individuals of prominence who receive compensation for services on a per-event basis. SB 500 also would not apply to "key employees" as defined by IRC section 416(i)(1)(A)(i).[59]

By introducing SB 500, California is attempting to join a growing list of states — Indiana, Kentucky, Michigan, Ohio, Pennsylvania, and West Virginia — that have enacted their own mobile workforce legislation. These laws may signal to Congress that states are independently seeking a solution to nonresident income taxation. If enough states follow suit, it arguably will be less likely that Congress will enact law in this area.

## IV. California Considers Various Proposals To Increase Revenue

The Legislature is also considering a variety of tax increase measures designed to fund the reintroduction of government programs that were cut during the state's prior financial crisis.[60] The proposals that have been or are expected to be introduced include a sales tax on services, a change to the application of Proposition 13 to businesses, an extension of the temporary sales and personal income tax increases enacted by Proposition 30, and the imposition of an oil extraction tax.

### A. Senate Seeks to Impose Sales Tax on Services To Offset Expiration of Proposition 30

On December 1, 2014, the Legislature introduced SB 8, proposing three broad changes to the CRTC. First, SB 8

[49]The MTC proposal was approved on July 27, 2011, and is very similar to the proposed federal legislation. The key differences are that the MTC proposal only exempts nonresident employees if they work less than 20 days per year in a state and if their state of residence offers a similar exclusion or does not impose an income tax.

[50]The amendment states that the additions made to the CRTC and the California Unemployment Insurance Code by SB 500 shall only remain in effect until January 1, 2021, and as of that date repealed.

[51]SB 500, section 1 (proposing to add Cal. Rev. & Tax. Code section 17952.7(b)(1)).

[52]SB 500, section 2 (proposing to add Cal. Rev. & Tax. Code section 18501.5(a)(2)).

[53]Cal. Rev. & Tax. Code section 17041(d)(2).

[54]*Id.*

[55]Cal. Rev. & Tax. Code section 18662(a).

[56]SB 500, section 2 (proposing to add Cal. Unemployment Ins. Code section 13020.5(a)).

[57]SB 500, section 3 (proposing to add Cal. Unemployment Ins. Code section 13020.5(b)).

[58]*Id.*

[59]SB 500, section 1 (proposing to add Cal. Rev. & Tax. Code section 17952.7(c)).

[60]Jessica Calefati, "California Budget: Senate and Assembly Approve a $117.5 Billion Spending Plan," *San Jose Mercury News*, June 15, 2015.

would impose a sales tax on services.[61] The legislation would exempt the following from tax: healthcare services, education services, and businesses generating under $100,000 of gross sales.[62] Further, under SB 8 the corporate income tax would be evaluated "to determine whether it is meeting its intended purposes, including whether it is borne equitably among California's businesses and what impact it has on the business climate, while at the same time linking changes to a more reasonable minimum wage."[63] Finally, SB 8 would examine revising the corporate net income tax and personal income tax if it can be shown that revenue generated from imposing a sales tax on services would be sufficient to replace revenue lost by revising those taxes.[64]

This is not the first time policymakers have attempted to impose a sales tax on services. In 1995, AB 194 sought to impose a tax on specific services, including the general repair and installation of tangible personal property as well as computer programming.[65] In 2005, AB 9 proposed to tax the gross receipts derived from 11 specialized services defined under a newly added section of the CRTC.[66] A draft of the 2009-2010 budget included language taxing some services, including admissions to sporting events and veterinary care.[67] In 2011 AB 1963 proposed imposing a broad tax on specific services combined with reducing personal income and sales and use tax rates.[68] Also in 2011, AB 2540 proposed a sales tax on specifically enumerated services.[69] None of these proposed tax increases were enacted into law.[70]

A survey conducted by the Public Policy Institute of California shows that most voters object to the taxation of services.[71] Thus, most lawmakers are seeking other ways to generate revenue for the state.[72] With the phaseout of Proposition 30's temporary sales and personal income tax increases beginning in 18 months (discussed below), many policymakers are seeking to extend the tax increases in order to continue generating revenue for the state.[73]

[61]SB 8, section 2 (proposing to add Cal. Rev. & Tax. Code section 6305).

[62]SB 8, section 1(o)(1).

[63]SB 8, section 1(o)(2).

[64]SB 8, section 1(o)(3) and (p).

[65]California Taxpayers Association, "State Tax on Services" policy brief, at 3 (Jan. 2013).

[66]*Id.*

[67]*Id.*

[68]*Id.*

[69]*Id.*

[70]*Id.*

[71]Mark Baldassare et al., "Californians and Their Government," Public Policy Institute of California survey (May 2015).

[72]*Id.*

[73]Chris Megerian, "Tax Proposals by Unions, Activists May Loosen Brown's Grip on Budget," *Los Angeles Times*, May 25, 2015.

### B. Newly Formed Coalition Seeks to Eliminate Proposition 13 Protections for Business Property

State Sens. Loni Hancock (D) and Holly Mitchell (D) have authored Senate Constitutional Amendment 5 (SCA 5), which proposes changes to Proposition 13. California voters passed Proposition 13 in 1978, establishing limitations on the imposition of property taxes. By its terms, Proposition 13 rolled back assessment values of real property to 1975 levels.[74] Of greater significance over time, however, was that Proposition 13 imposed restrictions on both property tax rate and real property assessed value increases. These include capping property tax rates at 1 percent of assessed value, limiting annual increases in assessed value to 2 percent, and prohibiting the reassessment to market value unless there is a change of ownership or the completion of new construction on the property.[75] The CRTC defines a change in ownership as a "transfer of a present interest in real property . . . the value of which is substantially equal to the value of the fee interest."[76] The CRTC provides further that under specified circumstances, a change of ownership or control of a legal entity, including a more than 50 percent change of direct or indirect ownership or control of it, may also be treated as a transfer of the real property owned by the legal entity, thus triggering reassessment of that property under Proposition 13.[77]

Introduced March 26, 2015, SCA 5 would authorize potential annual increases in property taxes on businesses by creating a split-roll real property tax system. This would provide for the annual assessment of business properties to their market value without the restrictions imposed by Proposition 13.[78] With some limitations, SCA 5 would generally require all commercial and industrial properties to be assessed at their full cash value, thus eliminating the Proposition 13 change of ownership requirement for reassessment as applied to those properties.[79] The proposal would not apply to residential and agricultural property, which would remain under the limits of Proposition 13.[80] Also, SCA 5 would exempt from property tax up to $500,000 in tangible personal property used for business purposes.[81] As of July 16, 2015, SCA 5 has been read twice in committee and re-referred to the Governance and Finance Committee.

[74]Cal. Const. Art. XIII A, section 2.

[75]*Id.*

[76]Cal. Rev. & Tax. Code section 60. *See also* Cal. Rev. & Tax. Code section 62, which enumerates transactions "excluded from 'change in ownership.'"

[77]Cal. Rev. & Tax. Code section 64.

[78]SCA 5, Second (proposing to add Cal. Const. Art. XIII, section 3.1).

[79]*Id.*

[80]SCA 5, Third (proposing to add Cal. Const. Art. XIII A, section 2.5).

[81]SCA 5, Second (proposing to add Cal. Const. Art. XIII, section 3.1(a)).

This effort to amend Proposition 13 comes on the heels of AB 2372, which failed in the Legislature in 2014. AB 2372 sought to amend Proposition 13 by redefining the change of ownership rules regarding transactions involving legal entities, from a change of "direct or indirect ownership or control of more than 50 percent of the voting stock" to "whenever 90 percent or more of the direct or indirect ownership interests in a legal entity are sold or cumulatively transferred."[82]

SCA 5, considered a tax increase, would require a two-thirds majority vote from both houses of the Legislature.[83] Hancock has admitted that "it's a high hurdle to get to two-thirds."[84] However, Make It Fair, a coalition of labor unions and community groups, has pledged to gather petition signatures for a ballot initiative if SCA 5 fails to make it through the Legislature.[85]

Even if SCA 5 makes it to the voters, according to a recent poll conducted by the Public Policy Institute of California, support for changing Proposition 13 has been dwindling.[86] The poll shows that 50 percent of likely voters say they are in favor of the split roll, the lowest that figure has been since the institute began asking this question in January 2012.[87]

### C. Proposed Extension of Increased Sales Tax And Personal Income Tax Rates

Proposition 30, passed by voters in November 2012, temporarily increased the state portion of the sales and use tax rates in California from 7.25 percent to 7.5 percent from January 1, 2013, to December 31, 2016.[88] Proposition 30 also increased, from January 1, 2013, through December 31, 2018, the individual income tax rate for individuals earning annual income over $250,000, couples earning over $500,000, and heads of household earning over $340,000.[89] Including the tax revenue to date from these Proposition 30 tax rate increases, the California Legislative Analyst's Office estimates that over $45 billion in revenue will have been generated for the state by the expiration of the income tax rate increases on December 31, 2018.[90]

The reduction in revenue that will occur as these temporary tax increases expire worries some lawmakers, but the governor's budget for 2015-2016 projects that the state should be able to maintain its fiscal health without Proposition 30 revenues.[91] And Gov. Jerry Brown (D) has publicly opposed extending the tax increases implemented by Proposition 30.[92] However, many Democratic lawmakers disagree with the governor and believe that Proposition 30 should be extended in order to ensure fiscal health and provide funding for additional spending.[93]

Should Democratic lawmakers seek to push the extension of Proposition 30 to a public vote despite Brown's opposition, they could use his strategy from 2012 and seek petition signatures.[94] The recent survey by the California Public Policy Institute states that 49 percent of Californians and 46 percent of likely voters would support extending Proposition 30.[95] However, only 33 percent of Californians and 30 percent of likely voters support making these tax increases permanent.[96]

### D. Environmentalist Seeks to Impose Tax On Oil Extraction

Tom Steyer, a billionaire environmentalist, has announced a proposal that would introduce a 10 percent oil extraction tax in California.[97] He estimates that its implementation could generate up to $2 billion in revenue,[98] which would be dedicated "to making higher education affordable to California residents."[99] However, California has a history of rejecting measures to tax oil extraction.[100] In 2014, SB 1017 proposed a tax on the extraction of oil and natural gas, but the bill did not make it out of the Appropriations Committee and has not been revisited.[101]

California is the only state out of the 22 major oil-producing states that has not implemented an oil extraction tax.[102] This is because historically, organizations opposing oil taxes have advocated against them on the grounds that they would increase energy costs for customers in the form of higher gas prices and higher prices for goods and services.[103] These arguments have proven persuasive with both the public and the Legislature, resulting in the continued rejection of oil extraction taxes in California.[104]

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[82]AB 2372, section 2 (proposing to amend Cal. Rev. & Tax. Code section 64(c)(1)(B)(i)).

[83]Calif. Const. Art. XIII A, section 3(a).

[84]Fenit Nirappil, "Democrats Propose Proposition 13 Overhaul for Businesses," *The Washington Times*, June 10, 2015.

[85]Phil Willon, "Support Dwindles for Changing Proposition 13," *Los Angeles Times*, June 3, 2015.

[86]*Supra* note 69.

[87]*Supra* note 83.

[88]*Supra* note 7.

[89]*Supra* note 9.

[90]Jason Sisney, Justin Garosi, and Seth Kerstein, "May Revision: Proposition 30 Estimates, Accrual Uncertainties," Legislative Analyst's Office, May 18, 2015.

[91]Gov. Edmund G. Brown, "Cal. 2015-16 Budget Summary, May Revision," (2015).

[92]Megerian, *supra* note 71.

[93]*Id.*

[94]*Id.*

[95]*Supra* note 69.

[96]*Id.*

[97]Michael Finnegan, "Tom Steyer Eyes New Oil Tax and Gas-Price Transparency," *Los Angeles Times*, May 15, 2015.

[98]Andrea Platten, "Environmentalist Tom Steyer Proposes State Oil-Extraction Tax to Potentially Benefit UC," *The Daily Californian*, May 19, 2015.

[99]*Supra* note 95.

[100]*Supra* note 96.

[101]SB 1017, section 3 (proposing to add Cal. Rev. & Tax. Code section 42301).

[102]*Supra* note 96.

[103]*Id.*

[104]*Id.*

Despite historical failures at the ballot box and little support from the governor's office, Steyer has announced plans to continue working with citizens to fine-tune the details of his proposal and then develop a plan to get his measure placed on the 2016 ballot.[105]

## V. Taxation of PPO Healthcare Companies

Another issue under consideration by the Legislature is the taxation of healthcare companies that have preferred provider organizations (PPOs).[106] The taxation of PPOs has been controversial for years because existing law in California allows PPOs organized under the Knox-Keene Act to be licensed and regulated by the Department of Managed Health Care and subject to the state's corporate income tax, rather than being regulated by the California Department of Insurance (DOI) and subject to the state's gross premiums tax.

AB 1434 as amended April 20, 2015, would modify California's Health and Safety Code to subject all PPOs to regulation by the DOI, thus imposing on them the gross premiums tax levied on insurers.[107] An initial hearing for AB 1434, scheduled for April 27, 2015, was canceled at the request of its author, but the bill still resides in the Assembly for further consideration.

AB 1434 could affect the taxation of healthcare companies with PPOs because it raises questions whether these types of entities would be included as part of a California combined return. Under Legal Ruling 385 (LR 385), the FTB considered whether a corporate insurer could be included on the combined return of a unitary business. In LR 385, the FTB states that insurance companies are generally under the regulation of the DOI and are thus subject to a gross premiums tax in California.[108] Therefore, an insurance company would not be subject to apportionment under CRTC section 25101 because it is not a taxpayer as defined under CRTC section 23037, which states that a taxpayer is a corporation subject to the franchise tax, the tax on preference income, or the corporate income tax.[109]

Because insurance companies are subject to the gross premiums tax, they do not meet the definition of a taxpayer for the purposes of CRTC section 23037, and the income and apportionment factors associated with them cannot be included in a combined report under CRTC section 25101.[110] Further, LR 385 states that insurance companies operating entirely outside California must be treated similarly because of the FTB's practice of uniform application of rules.[111] Therefore, if AB 1434 is passed, it raises the possibility that all the income and apportionment factors associated with healthcare companies with PPOs would not be included in a combined report, which would lead to issues concerning combined filing, the treatment of intercompany dividends, and the apportionment for these companies.

## VI. Conclusion

Each one of the measures discussed above could affect state taxation in California. Over the next year, lawmakers will work to push their measures either through the state Legislature or on the 2016 ballot to coincide with the presidential election. As a result, taxpayers may face a number of significant law changes in the coming tax years.

Taxpayers should consider how these proposed law changes would affect their tax liability. If enacted into law, these proposals will transform what had appeared to be a relatively quiet legislative session and create plenty of noise. Taxpayers may wish to listen carefully as the 2015-2016 session unfolds. ✰

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[105] *Id.*

[106] A PPO is a managed healthcare plan that contracts with doctors and hospitals to create a network of participating providers.

[107] AB 1434, section 2 (proposing to add Cal. Health and Safety Code section 1396.6).

[108] *Id.*

[109] *Id.*

[110] *Id.*

[111] *Id.*