Tax readiness: California - Key developments in the Golden State

August 21, 2019

In brief

The size of the market, expanded nexus standards, unitary combination, and the complexity of state regulations are among the factors making California tax rules and procedures a top concern for state and local tax departments. From a tax policy perspective, taxpayers have been focused on the state's response to federal tax reform legislation (the Act), initiatives that impact sales and use taxes - including the state's response to the *Wayfair* decision - and property taxes. Also of note is the recent revamp of the state's tax appeals process under which appeals are now heard by a new Office of Tax Appeals.

PwC on August 14 hosted a webcast featuring specialists who discussed these issues. This insight highlights those discussions.

The next Tax Readiness webcast —A year after *Wayfair:* How do sellers and marketplace facilitators comply with indirect taxes? — is scheduled for September 11, from 2:00 PM - 3:00 PM (EDT).

In detail

State of the State

Revenue

Before examining specific state tax policies, it is important to understand where the state derives the bulk of its revenue. For California, the personal income tax by a wide-margin is the largest contributor to the state's general revenue fund at over 70%. Sales and use taxes generate just under 19% of the fund's revenue, and the corporate tax generates just under 9% of the revenue. Although revenue has been on the rise since 2011, in any upcoming economic recession, the state could experience a decline in revenues of up to $70 billion.

These revenue numbers and the volatility of California's revenue streams are considerations as the state implements tax policy and crafts policies for the future.

Tax reform and other initiatives

Tax reform

Like all states, California has had to address the potential state impacts of federal tax reform. California does not automatically conform to changes in federal tax law. Instead, the state must affirmatively conform to federal changes. On July 1, Governor Gavin Newsom (D) signed Assembly Bill 91, a federal tax conformity package. Highlights of the bill include:

- Repealing net operating loss carrybacks, for tax years beginning on or after January 1, 2019. The state did not did not conform to other federal

NOL changes in the Act (such as limiting carryovers to 80% of taxable income with an unlimited carryover period).

- Conforming to the federal elimination of like-kind exchange treatment for exchanges of personal or intangible property, limiting these exchanges only to real property, except for personal income taxpayers with less than $250,000 of adjusted gross income (AGI) for a single filer and $500,000 of AGI for a joint filer. The California rule applies to exchanges completed after January 10, 2019.
- Providing that if an election under IRC Sec. 338 is made to treat a qualified stock purchase of a target corporation as an asset acquisition by the purchasing corporation for federal tax purposes, a separate state election is not allowed. In addition, if no federal election is made, a separate 338 state election is not allowed.
- Conforming to the federal repeal of provisions that treat a partnership as terminated on the sale or exchange of 50% or more of the interest in a partnership within a 12-month period. This provision is operative for tax years beginning on or after January 1, 2019, but allows a partnership to elect to have this conformity apply to partnership tax years beginning after December 31, 2017, and before January 1, 2019.

Observation. The state does not conform to some of the more significant federal corporate changes included in the Act, such as the international provisions (Global Intangible Low-Taxed Income (GILTI), Foreign-Derived Intangible Income (FDII), and Base Erosion and Anti-Abuse Tax (BEAT)), IRC Sec. 163(j) interest limitations, and full expensing. The conformity package is intended to raise $1 billion in 2019-2020 and $680 million in 2020-2021 to finance the expansion of the California Earned Income Tax Credit (EITC).

The Act also created the Opportunity Zone Program, which provides incentives to investors that invest capital into low-income communities and promotes long-term economic growth through a variety of investment vehicles. Governor Newsom is refining his proposal for limited conformity to the federal program, with a focus on incentivizing investment in green technology and affordable housing.

Observation: When asked during the August 14 webcast to identify their biggest concern regarding California and federal tax reform, 31% said the repeal of NOL carrybacks; 8% said the limit on like-kind exchanges; 11% said the elimination of California-only IRC Sec. 338 election, and 50% reported "other" concerns.

Tax on services

While California's response to the *Wayfair* decision has attracted considerable attention (discussed below), another proposal impacting the sales tax base also has generated a lot of interest.

Senate Bill 522, introduced in February by Senator Bob Hertzberg, would impose the sales tax on services. The findings of the bill assert the state's over-reliance on personal income taxes as a revenue source, given its volatility. Currently, the bill language only provides a statement of intent, with no specifics as to what services would be taxed or when such tax would commence. The bill remains in committee. Recent discussions include exempting business-to-business services from a new levy.

Observation: Taxpayers should follow this issue closely. If tax revenues were to decline, this proposal could gain traction quickly.

Property tax - Split-roll initiative

Taxpayers with property in the state need to be aware of an initiative that will be presented to California voters at the November 2020 general election: a proposal to amend California's Proposition 13 by allowing certain commercial and industrial real property to be taxed at fair market value, rather than based on the purchase price. Estimates are that this would be a tax increase of anywhere from $6 billion to $11 billion. The revenue would be allocated to schools and local governments. Small businesses and agricultural land and up to $500,000 of tangible property would be exempt from the fair market value assessment.

Observation: The split-roll initiative is not polling well among California voters and proponents are gathering signatures for a modified version to be placed on the 2020 ballot; as a result, the Governor and legislative leaders may seek a compromise on this issue to avoid a campaign that may have long-term ramifications.

False Claims Act

A proposal to amend the state's False Claims Act also might be of concern to taxpayers. Assembly Bill 1270, introduced by Assembly member Mark Stone, would expand the reach of the False Claims Act to tax matters where (1) damages pleaded exceed $200,000, and (2) the person who made the false claim has more than $500,000 of taxable income under the Personal Income Tax, net income under the Corporate Income Tax, or sales under the Sales and Use Tax.

The proposal would allow the Attorney General, public entities, and private attorneys retained by public entities to bring civil actions on behalf of *qui tam* plaintiffs (whistleblowers) to recover treble damages and civil penalties against any person who knowingly makes or uses a false statement or document to either obtain money or property from the state or avoid paying or transmitting money or property to the state.

Observation: The False Claims Act has been applied to non-income tax matters in Illinois, generating significant litigation especially in the area of sales and use taxes. Whereas Illinois bars application of the False Claims Act to income taxes and is silent with respect to other taxes, California's proposal is similar to New York's law, which specifically applies the False Claims Act to taxes based on meeting certain thresholds.

Observation: When asked during the August 14 webcast to identify the most significant tax threat faced by their company in California, 43.5% of respondents said an increase in the corporate tax rate, 40% said the proposed sales tax on services, 12% said the split roll property tax initiative, and 4.5% said the application of the False Claims Act to tax.

California's response to *Wayfair*

Legislative response - nexus

On June 21, 2018, in a 5-4 decision, the US Supreme Court in *South Dakota v. Wayfair* overruled the physical presence requirement for substantial nexus under the Commerce Clause as set out in the *Quill* decision. In *Wayfair*, the Court found that the physical presence rule is an "incorrect interpretation of the Commerce Clause."

Since the *Wayfair* decision, California and other states have responded by enacting provisions to create economic nexus standards for sales and use tax collection. California's response was enacted on April 25 when Governor Newsom signed AB 147. The legislation provides that on or after April 1, 2019, a retailer engaged in business in the state includes any retailer that, in the preceding calendar year or the current calendar year, has total combined sales of tangible personal property for delivery in the state that exceed $500,000, regardless of the number of sales transactions. Combined sales of tangible personal property include both the retailer's sales and all persons related to the retailer.

For determining if a marketplace seller must register, a marketplace seller will include all sales of tangible personal property for delivery in California, including sales made on its own behalf and sales facilitated through any marketplace facilitator's marketplace. A marketplace seller will register with the California Department of Tax and Fee Administration (CDTFA) for retail sales made on its own behalf and not facilitated through a registered marketplace facilitator.

The CDFA, in its discretion, may relieve a retailer engaged in business in California from penalties and interest if: (a) the retailer registered on or after April 1, 2019, as a retailer engaged in business in the state; (b) the total combined tangible personal property sales of the retailer and all persons related to the retailer within the preceding 12 months in California or for delivery in California do not exceed $1 million; (c) the retailer was not previously registered or required to register with the CDTFA; (d) the retailer's failure to collect and remit use tax was due to a good faith error and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect; and (e) the retailer is not a marketplace facilitator. Such relief can be granted for tax reporting periods beginning April 1, 2019, and ending December 31, 2022.

Observation: Subsequent to the US Supreme Court's *Wayfair* decision, the CDTFA announced stopgap rules that required remote retailers beginning April 1 to collect and remit tax if they had $100,000 or 200 separate transactions in the state in a year. The retroactive application of AB 147 to April 1 is due to the legislature's desire to override the CDTFA's rules and reduce the burden for some small sellers.

Local taxes

In addition, AB 147 provides that as of April 1, 2019, the definition of a retailer engaged in business in a district (i.e., a locality) for local use tax purposes includes any retailer that in the preceding or current calendar year has total combined sales of tangible personal property in the state that exceed $500,000. Previously, retailers must have had a physical presence in the district before being required to collect that district's taxes beyond the basic state rate.

Under the new law, taxpayers that have exceeded the threshold must collect tax based on the destination tax rate. This local tax impact was emphasized by the CDTFA when it updated Special Notice L-591 to specifically provide that beginning April 25, 2019, all retailers required to be registered in California, whether located within or without the state, must collect local district use tax on all sales made for delivery into *any* district that imposes a district tax if, during the preceding or current calendar year, the total combined sales of tangible personal property into the *state* by the retailer and all persons related to the retailer exceed $500,000.

Marketplace facilitators

AB 147 also provides that, effective October 1, 2019, a marketplace facilitator is considered the seller and retailer for each sale facilitated through its marketplace for purposes of determining whether it is required to register with the CDTFA. This includes all sales made on its own behalf and on behalf of all related persons, as well as sales facilitated on behalf of marketplace sellers. Any marketplace facilitator that is registered or required to register and that facilitates a retail sale of tangible personal property must collect and remit tax on those sales. The state has adopted certain relief provisions for marketplace facilitators.

Observation: When asked during the August 14 webcast which scenario best describes their company in a post-*Wayfair* environment, 50% of respondents said their company was already collecting and remitting tax to the state, 35% said that their company is not a seller or does not make taxable sales into California, 6% said that as a result of the new legislation, their company has started to collect and remit California tax, and 9% said that their company is struggling with the local tax implications.

New Office of Tax Appeals

Creation of OTA

Apart from the legislative changes discussed above, one of the most notable changes to occur in California in the last few years was the 2017 enactment of AB 102, which shifted nearly all tax administration and appeal functions from the Board of Equalization (BOE) to two new tax departments: the California Department of Tax and Fee Administration (CDTFA) and the Office of Tax Appeals (OTA). The OTA is tasked with hearing sales and use tax appeals from the CDTFA and personal and corporate income tax appeals from the Franchise Tax Board (FTB) starting January 1, 2018. The OTA was created due to perceived flaws in the appeals process previously conducted by the BOE.

What is new and what is the same?

Appeals of the new OTA have some similarity with appeals handled by the BOE: timelines for filings are similar; taxpayers continue to have the "last word" and can file the last brief; additional briefings are typically allowed if requested by either party; any authorized person can represent a taxpayer before the OTA; and taxpayers can appeal unfavorable OTA decisions to the Superior Court, but the FTB and CDTFA cannot.

Nevertheless, there are several differences: The OTA tends to allow additional briefing time - beyond the normal schedule; there is limited interaction with administrative law judges of the OTA prior to the hearing, whereas BOE members generally were available; there is an additional pre-hearing conference between the opposing parties and the lead ALJ; there is no hearing summary issued stating the parties' respective positions before the hearing; and the ALJ panel issues decisions within 100 days of the hearing - the BOE typically made its decision at the hearing.

Since convening in 2018, over 90% of OTA decisions are related to franchise and income tax matters. Less than 10% are related to other business taxes, mostly sales and use taxes. Most cases have not involved deeply interpretive sections of the tax law, or sections with nuances, but on more routine issues.

Observation: When asked during the August 14 webcast whether the company was considering an appeal to the Office of Tax Appeals, 8.5% of respondents said with the next six months, another 8.5% said within one year, 8% within two years or longer, and 75% said never or that their business has no California controversies.

The takeaway

Typically, California is the state of most concern for multistate US businesses. Businesses should watch for tax increases, including potential property tax increases caused by the split-roll initiative or "compromise" increases in the corporate income (franchise tax) or sales and use tax, including proposals to tax services.

For businesses that had nexus in California before the nexus expansion enacted under AB 147, the legislation offers sellers an opportunity to come forward, register, and pay without incurring any penalties and interest if the requirements listed above are met.

In terms of appeals, there is little guidance yet as to how the OTA will rule on certain issues, especially in complicated matters where there is a higher measure of uncertainty. In the interim, it may prudent generally to limit appeals to issues where there is more legal clarity.

Let's talk

If you would like to discuss how these developments may affect your business, please contact:

State and Local Tax Services

Jon Sperring, partner
+1 (916) 601-9707
jon.a.sperring@pwc.com

Jennifer Jensen, partner
+1 (240) 599-6537
jennifer.jensen@pwc.com

Kate Dill, director
+1 (916) 995-1986
kathleen.p.dill@pwc.com