

State Checklist

California

Net Operating Losses (NOLs)

The law allows corporate taxpayers to utilize net operating losses, carryovers, and carrybacks for the purpose of offsetting tax liabilities.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• The NOL deduction is suspended for the 2010 and 2011 taxable years for a taxpayer with pre-apportioned income of \$300,000 or more.<ul style="list-style-type: none">○ The bill disallows NOL carrybacks for any NOLs attributable to taxable years beginning before January 1, 2013.○ Although the utilization of NOLs has been disallowed for the taxable years of 2010 and 2011, the carryover period has been extended for NOLs, thereby allowing the taxpayer to have the same number of years to utilize the deduction as if the disallowance of 2010 and 2011 had not occurred.
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Credit Assignment

Eligible credits may now be assigned to eligible assignees during taxable years beginning on or after January 1, 2008. An eligible credit is any credit earned by the taxpayer for taxable years beginning on or after July 1, 2008 or any credit earned by the taxpayer for taxable years beginning on or before July 1, 2008 that is eligible to be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008. An eligible assignee is any affiliated corporation that is properly treated as a member of the same combined reporting group pursuant to R&TC section 25101 or 25110 as the taxpayer assigning the credit.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• Assigned credits may only be utilized during taxable years beginning on or after January 1, 2010. Assignee of credit completes FTB Form 3544A<ul style="list-style-type: none">○ The election to assign credits is made on FTB Form 3544 and is irrevocable. All credits assigned are subject to the same utilization percentage, carryover periods and expiration dates as credits that are not assigned.
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Large Corporate Underpayment Penalties

Prior law imposed a 20% penalty on all corporate taxpayers understating their tax by more than \$1 million for taxable years beginning on or after January 1, 2003. The penalty was imposed on the entire understatement assuming the \$1M threshold was breached.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• For each taxable year beginning on or after January 1, 2010, the law was softened somewhat. The penalty for the understatement of tax will now apply if the tax liability exceeds the greater of \$1,000,000 or 20% of the tax shown on the original or amended return. The penalty is not assessed if understatement is a result of change in law or reasonable reliance on a Chief Counsel ruling.
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Foreign Dividends

R&TC Section 24411 provides for a dividend received deduction for dividends that are received from a partially included Controlled Foreign Corporation (CFC). The California FTB issued a Technical Advice Memorandum (TAM) reiterating its position that dividends paid by a partially included CFC of a water’s edge filer must be treated as coming first from the current year’s earnings until exhausted and then from the most recent years’ earnings under the Last-in-First-Out (LIFO) ordering method. The TAM directs FTB staff to treat dividends as paid first from a year’s unitary earnings and therefore eligible for elimination under R&TC section 25106, until those earnings are depleted and then from excluded earnings eligible for the 75% DRD under section 24411.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• R&TC section 25106 provides that dividends paid from one member of a unitary group to another member of the unitary group are eliminated from the recipient’s income to the extent the dividends are paid from previously taxed income (included income). Taxpayers who previously filed on the worldwide combined method and generated earnings previously subject to tax.• Taxpayer’s who subsequently make a water’s edge election are required under R&TC section 25110 to include in its water’s edge return a portion of certain CFCs income and apportionment factors. The amount included is computed using a ratio of the CFCs Subpart F income to total earnings and profits (inclusion ratio).• R&TC section 24411 provides a 75% deduction for certain dividends not eliminated under R&TC section 25106 (or which arise from the earnings of the partially included CFC).<ul style="list-style-type: none">○ The TAM provides for the ordering of those dividends and announced (1) the LIFO ordering method will be applied to determine the order of year(s) from which dividend distributions are made, starting with the current year, and after that year’s earnings are depleted, moving to the next most recent year; and (2) dividend distributions within a year will be treated as paid first from that year’s earnings eligible for elimination under R&TC section 25106, until those earnings are depleted, and then from earnings eligible for deduction under other provision of the tax law until those earnings are depleted.
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Deferred Intercompany Stock Accounts (DISA)

California regulation requires taxpayers to defer intercompany transactions between members of a combined reporting group until a triggering event occurs, such as when one of the parties to the transaction leaves the unitary combined reporting group (such as by partial sale, liquidation or no longer in the combined group, etc.). Distributions are dividends to the extent that they are paid out of E&P. Once current year and accumulated E&P is exhausted any additional distributions will reduce the shareholders stock basis. Distributions in excess of the distributing subs stock basis will be treated as a capital gain and deferred.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• DISAs are required to be disclosed annually, and if not disclosed the FTB may require the DISA to be taken into income.<ul style="list-style-type: none">○ Disclosure is on FTB Form 3726 and must be made on a specific entity basis and for each DISA by the corporation that received the distribution.
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Sourcing Sales of Services

California law requires taxpayers to use cost of performance when assigning sales of other than tangible personal property to the state where the income producing activity occurs. If the income producing activity occurs in more than one state, the receipts are assigned to the state where the greater proportion of the income producing activity occurs based on the costs of performing those activities.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• The California FTB amended the apportionment regulation to include in the definitions of income producing activity and costs of performance the services performed by an agent or independent contractor on behalf of the taxpayer.• The definition now expressly includes the rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer or the utilization of tangible and intangible property by the taxpayer or by an agent or independent contractor acting on behalf of the taxpayer in performing a service.• Cost of performance is amended to include a taxpayer’s payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property which give rise to the particular item of income.
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Franchisor Special Apportionment Rule, Chief Counsel Ruling 2010-2

Franchisors are required to use a three-factor apportionment formula in which receipts from franchising must be sourced under a modified market based approach including a throwback rule.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• Chief Counsel Ruling 2010-2 applied the broad definition found in Cal. Reg. 25137-3(a) which defines franchising as: “a trade or business which includes the granting of a license by a taxpayer (franchisor) of a trademark, trade name or service mark, to market or use a product or service under such trademark, trade name or service mark in accordance with methods and procedures prescribed by the taxpayer.”<ul style="list-style-type: none">○ The ruling basically held that a non-franchising business that included licensing its trademark for use on products marketed by the licensee fell under this definition requiring the use of special franchisor sourcing rules and allowing for the assignment of the royalty to the state of use (if the taxpayer is otherwise taxable in that state).
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Bonus Depreciation

Federal law has provided corporate taxpayers additional bonus depreciation of eligible assets commencing after tax years 2001 to 2010. The Small Business Jobs Act of 2010 extended the 50% bonus depreciation allowed in 2008 and 2009.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• Most states conform to the Internal Revenue Code as of certain or specified dates. However, although these states conform to the IRC they will decouple from specific provisions. Consequently, most states have decoupled from the bonus depreciation.<ul style="list-style-type: none">○ The following states however either conform to bonus depreciation or allow some form of the bonus depreciation deduction: These states should be reviewed to determine if a deduction is allowed.○ Alaska, Colorado, Delaware, Florida, Idaho, Illinois, Kansas, Louisiana, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Oklahoma, Pennsylvania, Utah and West Virginia.
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Asset Expense Election Under IRC Section 179

Under IRC section 179, taxpayers may elect to expense in the year the asset is acquired rather than depreciating the asset over a period of years. The expense deduction is phased out on a dollar-for-dollar basis once the taxpayer's total investment in qualified depreciable property for the taxable year exceeds a threshold amount. The Small Business Jobs Act of 2010 increased the asset expensing limit for the 2010 and 2011 tax years to \$500,000 and the phase-out threshold to \$2 million.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• Most states have decoupled from IRC section 179 or otherwise require an addition adjustment based on the difference of the federal expense amount and the amount allowed by the state.<ul style="list-style-type: none">○ The following states should be reviewed to determine if the state allows some conformity with the federal deduction: Alaska, Colorado, Connecticut, Delaware, Florida, Georgia, Illinois, Kansas, Louisiana, Massachusetts, Michigan, Mississippi, Missouri, Montana, New Mexico, North Carolina, North Dakota, Pennsylvania, South Carolina, Tennessee, and Utah.○ Other states may allow a limited expense deduction based on that state's expense limit or threshold and should be reviewed.
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Domestic Production Activities Deduction, IRC Section 199

The federal American Jobs Creation Act of 2004 created the section 199 production activity deduction. The deduction effectively reduces the federal corporate income tax rate by 9% at full phase in 2010.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• Most states decouple from this IRC provision and require an addition adjustment to state taxable income.<ul style="list-style-type: none">○ The following states may allow some form of conformity to the federal provision and should be reviewed to determine if the state will allow a deduction: Alabama, Alaska, Arizona, Colorado, Delaware, Florida, Idaho, Illinois, Iowa, Kansas, Louisiana, Missouri, Montana, Nebraska, New Mexico, Oklahoma, Pennsylvania, Rhode Island, Utah, Vermont, and Virginia (limited after 1/1/2009).
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Combined Reporting

Combined unitary reporting is not so much a type of return as the name given to the calculations by which a unitary business group apportions its income. In contrast to a consolidated return which involves the filing of a single return for a group of affiliated corporations.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• About 20 states require members of a unitary group to compute their taxable income on a combined basis.<ul style="list-style-type: none">○ These states are Alaska, Arizona, California, Colorado, Idaho, Illinois, Kansas, Maine, Massachusetts (effective in 2008), Michigan (effective in 2008), Minnesota, Montana, Nebraska, New Hampshire, New York (effective in 2007 and requires substantial intercorporate transactions), North Dakota, Oregon, Texas (effective 2007), Utah, Vermont (effective in 2006) and West Virginia (effective in 2009).○ The District of Columbia is going combined in 2011. Maryland is still considering combination and requires the combined filing disclosure for 2010.○ See Chart of Combined Reporting states○ See Chart of states requiring Water's Edge, Worldwide, or an election○ Arizona recently provided in <u>RR Donnelly & Sons Co. v. Arizona Department of Revenue</u> that there be substantial intercorporate transactions between entities in order to combine.○ North Carolina in <u>Delhaize America Inc. v. Lay</u> upheld the forced combination of Delhaize with an affiliate that conducted substantive business operations and
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	<p>licensed intangibles. North Carolina adopted legislation in 2010 that provides that taxpayers may only file on a combined or consolidated basis if (1) directed to do so by the secretary; (2) its facts and circumstances meet those specified in a permanent rule adopted by the secretary; or (3) the taxpayer requests and receives from the secretary written guidance directing it to file on a consolidated or combined basis. In response, the Secretary has issued a draft of combined corporate income tax rules in regulation form and which basically provide that combination will be required, in addition to stock ownership and the existence of a unitary business, where reporting on a separate basis does not disclose the true earnings of the corporation on its business carried on in the state. Intercompany transactions in excess of cost indicate that true earnings are not reported, regardless of any transfer pricing study in support of the charges. The issue continues and in April, 2011, North Carolina proposed legislation to clarify when the Department of Revenue may require a combined report, and limits the Secretary's authority to require a combine return to those instances where other reasonable means to accurately report the taxpayer's net income are ineffective and creates a rebuttable presumption that a combined return is not required if the corporation comply with the economic substance doctrine.</p> <ul style="list-style-type: none"> ○ Apportionments of sales of tangible personal property are pursuant to Joyce or Finnigan principles. Joyce requires nexus of the separate entity whereas the Finnigan principle determines nexus of the entire group if any member of the combined group has nexus in the state. West Virginia adopted Joyce in 2010. Massachusetts adopted Finnigan for tax years on or after 1/1/2009; Maine adopted Finnigan for tax years on or after 1/1/2010 (prior to this date it used Joyce); California adopts Finnigan for tax years after 1/1/2011; Other Finnigan states are Arizona, Indiana, Kansas, Michigan, New York, Utah and Wisconsin.
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Nexus

Nexus is the amount of business activities that must be present in a state before that state can impose a corporate income tax. Public Law 86-272 provides protection for corporations selling tangible personal property and conducting certain limited activities in the process. The ability of states to claim that corporate level income taxes could be required through economic rather than physical presence has grown in the recent years. The MTC has endorsed this position in model legislation that basically provides the finding of economic nexus if during the period the taxpayer has (1) \$50,000 of property; (2) \$50,000 of payroll; (3) \$500,000 of sales or (4) 25% of its total property, payroll or sales in the state.

<input type="checkbox"/> Applies	<ul style="list-style-type: none"> • Colorado enacted a substantial nexus standard based on the above effective 1/1/2010 • Connecticut implement a bright line standard effective 1/1/2010 that finds economic nexus if activities create \$500,000 attributable to Connecticut sources. • Washington imposes an economic nexus standard for the B&O tax effective 6/1/2010. Historically, a person was required to have physical presence in the state to have nexus. Now an out-of-state business will be subject to Washington B&O tax on services and royalty income if the business meets one of four criteria: <ol style="list-style-type: none"> 1. More than \$50,000 of property in Washington; 2. More than \$50,000 of payroll in Washington; 3. More than \$250,000 of receipts from Washington; or 4. At least 25% of the taxpayer's total property, total payroll or total receipts are located in Washington. • New Jersey in <u>Telebright Corp. v. Division of Taxation</u> found that the presence of a full time telecommuting employee working from a home office established nexus. The employee worked on developing software and did not nor did the company solicit orders in the state.
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Single Sales Factor

At one time, most states utilized the evenly weighted three factor apportionment formula as set forth in UDITPA. Many states subsequently started double weighting the sale factor. Currently, states are starting to move to a single sales factor in order to place more of the tax burden on out-of state corporations and create economic incentive for an in-state corporation.

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• The following states currently utilize a single sales factor: Colorado, Georgia, Illinois, Iowa, Maine, Michigan, Nebraska, New York, Oregon, Texas, and Wisconsin.• The following states are phasing in a single sales factor and currently use a heavily weighted sales factor: Arizona, Indiana, Minnesota, Pennsylvania, and South Carolina.• California implements a single sales factor election for tax years 1/1/2011. Legislation is proposed to eliminate the election and make single sales mandatory.• Arizona is phasing in a single sales factor beginning in 2014 with full phase in by 2017.• Missouri allows an option between an even weighted three factors and single sales factor.• Utah is phasing in single sales factor starting in 2011 with full phase in 2013.• New Jersey is phasing in single sales in 2014 and requires 70% sales in 2012 and 90% sales in 2013.
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Other States Current NOL Rules

<input type="checkbox"/> Applies	<ul style="list-style-type: none">• Massachusetts extends NOL carryforwards to 20 years for NOLs incurred after 1/1/2010 and beyond. NOLs prior to this date are carryforward at 5 years.• Pennsylvania raises its NOL cap to 20% of taxable income or \$3 million for tax years beginning after December 31, 2009.• Maine has suspended NOL deductions for 2009, 2010 and 2011
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