SPIDELL'S
CALIFORNIA TAXLETTER®

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AUGUST 2018 VOLUME 40.8

Physical presence no longer required for sales tax

States are now free to tax internet transactions, subject to certain limitations.

By Sandy Weiner, J.D.
California Editor

In one of the biggest tax cases in decades, the U.S. Supreme Court reversed over 50 years of precedence when it ruled that an internet retailer does not need to have physical presence in a state before being required to collect sales tax on purchases to customers in that state.[1] The Court ruled that a previous Supreme Court case, ***Quill Corp. v. North Dakota***, was essentially wrongly decided from the get-go and that it was up to the Court and not Congress to correct the error.

This means that simply having sales in a state is enough to create nexus for sales and use tax purposes. The decision opens the door for states to enact laws similar to the one in South Dakota, where they impose sales tax on businesses with no physical presence in the state.

The big question now is how many sales must be made before the sales tax collection requirements may constitutionally kick in. We can expect that this issue, and other related issues, may be litigated for years to come.

Economic nexus thresholds

Now states are left to draft legislation that will pass the Constitutional requirements that the tax:

1. Apply to an activity with a "substantial nexus" with the taxing state;
2. Be fairly apportioned;

3. Not discriminate against interstate commerce; and
4. Be fairly related to the services the state provides.

The Court held that South Dakota's law met the substantial nexus requirements by only requiring out-of-state businesses to collect sales tax if they:

- Deliver more than $100,000 of goods or services to South Dakota addresses; or
- Engage in 200 or more separate transactions for the delivery of goods and services into South Dakota.

For the big internet retailers like Amazon, this isn't a problem because Amazon already collects taxes in all 50 states on its sales (not on third-party sales made on its site). But smaller online retailers might find themselves having to comply with a myriad of state and local sales and use tax requirements.

Comment

Some commentators have questioned whether the number of transactions should be a consideration for economic nexus or whether the Court and states should focus solely on the revenues earned in each state. Remember, the economic nexus standards must still meet the Commerce Clause's requirement that there be "substantial nexus." For example, would an app developer really have substantial nexus with a state if 200 people downloaded a 99¢ app?

Other important issues

The Court remanded the case back to the South Dakota Supreme Court to determine if the law meets other requirements of the Commerce Clause but indicated that it might be otherwise constitutional because South Dakota:

- Allows a small merchant exception;
- Applied the law prospectively only; and
- Is a member of the Streamlined Sales and Use Tax Agreement (SSUTA).

The Court stated that these issues were important especially in light of the burden that might be placed on small and start-up businesses. The Court noted that SSUTA, of which 20 states are currently members, standardizes taxes to reduce administrative and compliance costs by:

- Requiring a single state-level tax administration and uniform definitions (which bypasses the numerous county, city, and special districts that taxpayers may need to contend with);
- Simplifying tax rate structures;
- Providing other uniform rules; and
- Providing access to state-provided free tax administration software.

The Court also noted that software is currently available, and ever-evolving, to assist taxpayers with various state sales and use tax compliance issues.

Will *Wayfair* lead to simplification?

The complexities resulting from different state definitions are a well-known source of contention for multistate businesses and their tax practitioners. There is a legitimate concern that these complexities may place an undue burden on small businesses operating in interstate commerce.

SPIDELL'S CALIFORNIA TAXLETTER® (ISSN No. 0194-8237) is published on the first day of each month by **Spidell Publishing, Inc.**®, 1134 North Gilbert Street, Anaheim, California 92801-1401. Telephone: (714) 776-7850. Fax: (714) 776-9906. Web site: www.caltax.com. E-mail: subscriptions@spidell.com. The subscription price is $129 for 12 months. Periodicals Postage Paid at Anaheim, CA.© 2018, Spidell Publishing, Inc®. **POSTMASTER:** Please send address changes to **Spidell's California Taxletter**, P. O. Box 61044, Anaheim, California 92803-6144. Federal law prohibits unauthorized reproduction of **Spidell's California Taxletter**®. All reproduction must be approved in writing by **Spidell Publishing, Inc**.® Publisher Emeritus: Robert Spidell. Publisher: Lynn Freer. Editor: Renée Rodda. California Editor: Sandy Weiner, J.D. Senior Editor: Tim Hilger. Contributing Editor: Kathryn Zdan. Contributing Editor: Diane Fuller. Managing Editor: Austin Lewis. Layout: Ana Cervantes.

As the dissent noted in its opinion, "Over 10,000 jurisdictions levy sales taxes, each with different tax rates, different rules governing tax-exempt goods and services, different product category definitions and different standards for determining whether an out-of-state seller has substantial nexus." A few examples:

- New Jersey knitters pay sales tax on yarn purchased for art projects but not on yarn earmarked for sweaters;
- Texas taxes sales of plain deodorant at 6.25% but imposes no tax on deodorant with antiperspirant;
- Illinois categorizes Twix and Snickers bars — chocolate-and-caramel confections usually displayed side-by-side in the candy aisle — as food and candy, respectively; and
- In California, sales of the Bible are generally taxable, but a Playboy subscription is not (although, a single issue bought at the newsstand is taxable).

Although Congress has been unable to pass legislation to address this issue in the past, the increased need for uniformity and simplification among the states given the ***Wayfair*** decision may be the catalyst that gets Congress to actually enact legislation in the near future.

Open questions

This case leads to some interesting questions that will need to be sorted out. For example:

- Is the ***Wayfair*** decision retroactive? One of the factors the court discussed in its remand directive to the South Dakota Supreme Court was that it felt the law was constitutional because it only applied prospectively. The Court implied that retroactive application of an economic nexus standard might violate the Commerce Clause's fair apportionment requirement;
- In those states (like California and New York) that are not members of SSUTA, will the purchasers still be liable for things like local district taxes, or will the online retailer be required to collect the district tax too? Requiring the online retailer to collect these local taxes may run afoul of the Commerce Clause's prohibition against burdening interstate commerce; and
- What role will internet marketplaces play? Several states are allowing or mandating internet marketplaces such as Amazon and eBay to either collect sales tax on behalf of their vendors or comply with detailed reporting requirements. However there are a lot of issues to address in this area, such as if a vendor is selling on numerous marketplaces, how does a marketplace determine if the individual vendor has exceeded the threshold?

California nexus

California defines a "retailer engaged in business in this state" as "any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty."[2] Historically, California has only required sales/use tax collection for those retailers with physical presence or click-through, agency, or affiliate nexus.

The California Legislature's tax policy committees have announced that they will be holding hearings on the ***Wayfair*** decision, and the CDTFA has stated that they are currently evaluating the ***Wayfair*** decision.

We anticipate that California will adopt an economic nexus standard similar to or more liberal than the South Dakota standard, and at least the economic nexus thresholds could be adopted by regulation alone. However, without some form of tax and rate simplification to address California's hundreds of local taxing districts with their various tax rates, it is questionable whether an economic nexus threshold alone would be sufficient to address the Commerce Clause concerns laid out in ***Wayfair***. A statewide simplified tax and rate would require statutory changes.

Impact on other states

How ***Wayfair*** will impact all the various states depends on each state's laws. Below is a link to Spidell's summary of each state's current nexus laws and what, if any, statements have been made by their tax departments in light of ***Wayfair***.

The table indicates whether a state has adopted an economic nexus threshold, whether the standard will be applied retroactively or prospectively, and whether the state is a member of SSUTA or has other simplified procedures in place.

www.caltax.com/spidellweb/public/editorial/CAT/0818CAT-nexuschart.pdf

Checklist for taxpayers selling goods online

Given the rapidly changing environment for taxpayers selling goods over the internet, taxpayers must act quickly. Below is a checklist for taxpayers and their preparers:

- ✓ Determine where sales are being made (both in terms of number of transactions and monetary value);
- ✓ Identify the nexus standards for those states and if registration is required in any states;
- ✓ Check to see if the state(s) made any announcements regarding ***Wayfair***;
- ✓ Find out if the sales are taxable or exempt in the state (although the economic nexus thresholds apply to total revenues whether or not the transactions are exempt, taxpayers may want to prioritize those states where the sales are taxable);
- ✓ If sales are exempt, determine what the state requires in terms of documentation;
- ✓ Determine what taxes are applied within the state (e.g., single statewide rate or multiple local rates); and
- ✓ Determine the reporting and payment requirements for the state (e.g., is e-filing or electronic payment required).

[1] *South Dakota v. Wayfair, Inc.* (June 21, 2018) U.S. Supreme Court, Case No. 17-494

[2] R&TC §6203(c)

MyFTB: Follow-up to July article on POAs

The FTB is considering making changes to simplify the process.

By Lynn Freer, EA
Publisher

After hearing from many of you that the FTB's new two-step opt-in process makes no sense, we spoke with the FTB to share your concerns.

The FTB has agreed to reevaluate the new process to see if enhancements can be made to better streamline the process for Power of Attorneys (POAs) and Tax Information Authorizations (TIAs) submitted using MyFTB.

One possible solution could be adding a check-a-box to request full online account access (opt-in) at the time a POA or TIA is submitted on MyFTB. Once the FTB approves the POA or TIA relationship, the taxpayer would receive the authorization code for full online account access. We'll let you know if they will be able to make these changes.

Comment

A TIA client is what we used to call a MyFTB tax preparer client.

The current problem

When a POA or TIA is submitted, the FTB will approve, reject, or make contact with the taxpayer for relationship verification within 15 business days. If the request does not require manual intervention or relationship verification, the request will process much faster. In fact, if you submit the request via MyFTB, it could process in as quickly as a day.

Once the POA or TIA is approved, the representative will be able to discuss (by phone, chat, or in person) client tax matters with an FTB customer service representative, per the POA or TIA privileges allowed. There have been no changes in this regard.

However, the representative will only have limited online access to client data. This means the representative will only be able to:

- View any notices and correspondence sent from the FTB in the last 12 months, including responses to Send Secure Message;
- Initiate Secure Chat with the FTB about confidential tax matters; and
- Send a Secure Message with attachments.

The limited online access does not provide any of the information necessary for filing, like estimated payments. To gain access to this information, the representative must request full online access, and the client must authorize the request.

The possible solution mentioned above would eliminate the need to take this second step because representatives could request full access when submitting the POA or TIA.

Relationship verification

In some instances, both POAs and TIAs will be subject to relationship verification prior to the relationship being approved. The FTB says this process is necessary so that they can better protect taxpayers against unauthorized access of taxpayers' records and information. With the increased threat of identity theft, they are taking extra precautions to ensure taxpayer data is protected.

Additional relationship verification may be required if the FTB has no record of a previous connection between you and the taxpayer. (This often happens if the client is new, or an issue is being handled by someone other than the person who prepared the return.)

The FTB will determine if verification with your client is needed within 15 business days of receiving the POA or TIA.

When the FTB cannot confirm the relationship using available information, they send your client a letter, FTB 1181 (POA) or FTB 1182 (TIA), requiring your client to contact them to confirm that they approve of your relationship request. If your client does not respond within 45 days, the FTB will reject the request, and the process must start over.

At the same time the FTB sends your client a letter, they will send you a letter (FTB 1183) notifying you that they require confirmation from your client before they can complete the request. We recommend you let your client know they will be receiving a letter and they must call the FTB.

Clarification

In the July 1, 2018, article, "MyFTB updates effective June 24 — client access changing," under the heading "Changes to the POA process," we failed to state that a representative with a POA relationship will receive an e-mail notifying them that a notice has gone out to the taxpayer.

However, a representative with a TIA relationship may view notices in the client's account but will not get an e-mail alerting them that a notice is there.

Soda tax wars escalate in California

The budget deal bans new local taxes on sodas and other groceries.

By Sandy Weiner, J.D.
California Editor

As part of a last-minute budget deal, AB 1838 (Ch. 18-61) was signed by the Governor to prohibit any local taxes from being imposed on sales of groceries in California through 2030. Although the bill applies to all groceries, the acknowledged purpose of the bill was to prevent any local governments from imposing new or increased local taxes on sodas and other sugar-sweetened drinks.

The bill was quickly negotiated and drafted when big soda companies and their allies committed over $7 million to promote a statewide initiative that, if approved, would have banned any local tax increase without receiving approval by two-thirds of the voters.

Local soda taxes

Four California cities — Albany, Berkeley, Oakland, and San Francisco — currently have laws in place imposing a local tax on sodas and other sugar-sweetened drinks, and three other cities were contemplating enacting similar ordinances.

The soda companies have spent a lot of money fighting these local taxes and similar legislation around the country. Philadelphia and Seattle have enacted a similar tax. Cook County, Illinois, home to Chicago, also passed a soda tax in 2017 but repealed the tax two months later.

AB 1838 allows the taxes currently imposed in Albany, Berkeley, Oakland, and San Francisco to continue to be imposed, but prevents these cities from increasing the tax and prohibits any other city from adopting a similar tax.

The prohibition applies to all taxes on groceries, including kombucha with less than 0.5% alcohol by volume, seasonings, and coffees and teas, but does not extend to local taxes on alcohol, cannabis products, and cigarettes and tobacco.

Statewide initiative filed

Within days of the legislation being enacted, the California Medical Association and California Dental Association filed an initiative with the Secretary of State's office to authorize a statewide 2¢ per ounce tax on sodas and sugary drinks. The initiative would also reverse the moratorium on local governments' authority to impose a similar tax.

Certain beverages would be exempt from the tax including infant formulas, 100% fruit or vegetable juices, certain diet sodas, and beverages in which milk, or soy, rice, or similar milk substitute is the primary ingredient.

If the initiative qualifies, it will be placed on the November 2020 ballot, sweetening the voter draw for the Presidential election.

What is a sugary drink?

As we saw with California's repealed snack tax, it is not always easy to determine what is or isn't subject to tax. Here are some of the strange results we might see:

- Lemonade would be subject to the tax unless it is sweetened with artificial, noncaloric sweeteners (say goodbye to Grandma's lemonade);
- Red Bull would be subject to tax, but triple espressos would be okay;
- Frappucinos would be taxed, but lattes would be okay as long as no sweeteners are added; and
- Chocolate milk is exempt unless it is "too chocolatey."

Credits generated by SMLLCs forever limited

The FTB addresses impacts of entity classification and credit assignments on the amount of credit carryovers.

By Sandy Weiner, J.D.
California Editor

Under California law, the use of credits generated by a disregarded entity such as an SMLLC is limited to the increase in the owner's regular tax (before reduction by any credits) from the disregarded entity.[1]

So what happens to this limitation if:

- The disregarded entity takes on a new member and becomes a partnership or changes its classification to be taxed as a corporation?
- The disregarded entity dissolves?
- The disregarded entity owner assigns the credit to another unitary group member?

The answer to all three questions: It doesn't matter.

Once the SMLLC credit limitation attaches, it applies indefinitely, unless a statute specifically makes the limitation inapplicable.[2] **Note:** Currently, only the Motion Picture Production Credit statutes remove the SMLLC credit limitation when the Motion Picture Production Credit is assigned or sold.[3]

Calculating the allowable credit

Determining the SMLLC credit limitation requires several steps:

1. The owner computes tax on all income by including the income and expenses attributable to the disregarded entity;
2. The owner recalculates the regular tax excluding the income and expenses attributable to the disregarded entity and subtracts this amount from the first amount;
3. The positive difference between the first and second amounts of tax, if any, is the maximum amount of credits of the disregarded entity that the owner may use for the tax year. If the second number is greater than the first number, the owner is not allowed to use any credits from the disregarded entity.

Example of California's credit limitation for disregarded entities: ABC, LLC, a single-member LLC, generated a New Employment Credit of $25,000. The single member is either a C corporation or an S corporation with total net income of $50,000, which is comprised of $100,000 of income not attributable to ABC and a $50,000 loss from the activities of ABC. Assume the tax rate on the C corporation is the regular 8.84%, and the tax rate on the S corporation is 1.5%. The minimum corporate franchise tax is $800.

Tax including income	C corporation	S corporation
Net income of ABC	($50,000)	($50,000)
Net income of member excluding ABC's net income	$100,000	$100,000
Total net income reported by member	$50,000	$50,000
(A) Tax including ABC	$4,420	$800
Total net income of member excluding income/loss attributable to ABC	$100,000	$100,000
(B) Tax excluding ABC	$8,840	$1,500
Credit allowable (A - B)	**$0**	**$0**

In the example above, any unused credit may be carried forward to future years to the extent that the law allows. However, if the LLC or the taxpayer does not generate sufficient income to use the credit before the carryforward period expires, the credit will be lost.

Change in SMLLC's classification/dissolution

A credit attributable to an SMLLC is essentially lost if an SMLLC changes its classification or dissolves, even if there are unused credit carryovers. This is because the owner of the SMLLC would no longer have any income attributable to the SMLLC. The only way a credit carryover could potentially be claimed is if the entity's classification is changed back to a disregarded entity during the credit carryover period.

Example of SMLLC credit limitation and change in entity classification: In Year 1, an SMLLC owned by a C corporation generates $10,000 in R&D credits, but because the C corporation's tax attributable to the SMLLC in Year 1 is only equal to $2,000, the C corporation is limited to claiming $2,000 in Year 1. If in Year 2 the SMLLC elects to be taxed as a corporation, the owner may no longer claim the $8,000 R&D credit carryover because it no longer has any tax that is attributable to income from the SMLLC.

The same result would occur if the LLC took on an additional owner and its classification changes to an LLC taxed as a partnership. Because the LLC is no longer an SMLLC, the original C corporation owner does not have income from the SMLLC in subsequent tax years and therefore cannot claim any of the credit carryover. The distributive income from the LLC taxed as a partnership does not count toward the SMLLC credit limitation.

Credit assignments

California law allows a member of a unitary group to assign a credit or credit carryover to another unitary group member provided certain conditions are met.[4] If an owner of an SMLLC assigns a credit generated by the LLC to another group member, the SMLLC credit limitations continue to apply after the assignment. Therefore, the only way the credit assignee could claim the credit is if the assignee had income attributable to the LLC.

1 R&TC §§17039(g), 23036(i)
2 FTB Technical Advice Memorandum 2018-01
3 R&TC §23685(c)(10)
4 R&TC §23663

Possible regulatory woes for tax professionals

EAs in Nevada just had a scrape with unfriendly legislation, and California is eyeing EITC return preparation fees.

By Kathryn Zdan, EA
Contributing Editor

Legislation passed recently in Nevada had the potential to seriously curb the ability for enrolled agents (EAs) to practice their trade. Fortunately, a Nevada district court ruled in favor of the EAs' right to practice.

However, the Nevada Attorney General has 30 days to appeal the decision. If the Attorney General doesn't appeal, there will be no changes for EAs practicing in Nevada.

Here are the details of the Nevada bill that would have created serious problems for Nevada EAs.

Under the legislation, EAs were prohibited from performing the following activities:[1]

- Preparing tax returns;
- Holding any fees for services not performed or not incurred (retainers);
- Negotiating with another person concerning the rights or responsibilities of a client (representation); and
- Providing any advice, explanation, opinion, or recommendation to a client about possible legal rights, remedies, defenses, options, or the selection of documents or strategies (tax planning).

These changes are the result of the legislation expanding the definition of "document preparation services" to include:

- Certain paralegals; and
- A person who, for compensation, assists a client in preparing all or substantially all of a federal or state tax return or a claim for a tax refund.

The legislation requires Nevada EAs to:

- Pay a $50 document preparation services registration fee and a $25 annual registration renewal fee;
- Undergo state and federal fingerprinting and pay attendant fees; and
- File a $50,000 surety or cash bond with the Secretary of State.

Surety bond costs are based on credit scores, so a person with average credit would pay $1,500–$2,500 for a $50,000 bond. An individual with bad credit could pay upwards of $5,000.

Without paying these fees and posting a bond, EAs are not allowed to perform the activities listed above — the activities that basically define what it is to be an EA.

The Nevada Society of Enrolled Agents is going after a permanent injunction of the legislation, and they believe they have a strong argument against what's seen as an attempt to regulate preparers who are already licensed by the Department of the Treasury.

Is California next?

On the California front, preparer regulation could be an issue in the near future because advocates for low-income taxpayers are worried that tax professionals are charging too much to prepare returns claiming the California EITC.

The concern is that low-income families are losing a big chunk of their refunds to tax preparation fees, which often aren't disclosed until it's time to pay the bill. There's been talk of forcing preparers to publish fees for preparing the EITC form or possibly regulating what can be charged to compute the credit. But anyone who prepares Form 3514 knows that it is not a simple form to complete, justifying extra charges.

For a single taxpayer with one W-2 job, no other income, and one qualifying child, completing the EITC shouldn't be a problem. But as soon as real life enters the picture, then filling out this form becomes much more complex.

Even that supposedly simple example can be complicated. For example, a taxpayer lives with his girlfriend and her child. The girlfriend doesn't work and the taxpayer supports them. Is her child a qualifying child? To seasoned tax preparers, no. But to an individual who hasn't studied tax law — yes.

While filing for a credit may not sound difficult, it's easy to get it wrong. The CalEITC4me website has a chart with a simple calculator.[2] For income sources, the calculator only asks for income from jobs, other earned income, and investment income. But there are many other sources of income that go into AGI, which is a limitation on the credit, and many taxpayers don't realize this.

1 NV Rev. Stat. 240.240; AB 324

2 http://caleitc4me.org/earn-it/

Taxpayer SOL on SOL

The FTB is given discretion as to how to apply overpayments to outstanding liabilities.

By Sandy Weiner, J.D.
California Editor

The FTB applied a taxpayer's overpayment to outstanding liabilities rather than issue a refund for the year of his refund claim.[1]

The taxpayer failed to file a 2006 return even after receiving a Notice of Demand. The FTB used his mortgage interest paid to estimate over $13,000 in delinquent taxes, penalties, and interest, which they began to collect in 2009. Over $7,500 of this amount was collected during the period between July 26, 2011, and April 10, 2012.

On July 26, 2012, the taxpayer filed a 2006 return showing a negative AGI and no tax liability, which the FTB treated as a refund claim. The FTB accepted the return, eliminated the outstanding tax liabilities, and reduced the penalties accordingly, which resulted in a $13,462 overpayment in the taxpayer's account.

Applying the statute of limitations on refunds,[2] the FTB determined that only the $7,500 paid within the year prior to filing the return was available to be applied to the deficiencies and/or to be refunded to the taxpayer. Therefore, the FTB applied this amount to the taxpayer's outstanding liabilities owed for 2004, 2007, and 2010, which was around $7,800.

Application of overpayment

The taxpayer argued that the FTB should have paid the refund claimed on the 2006 year, but because the FTB applied the $7,500 paid within the last year to the other tax years, the OTA ruled that the remaining overpayment was barred by the one-year statute of limitations.

The OTA decision does not go into a great deal of detail. We can presume that the taxpayer argued that the amounts paid prior to the one-year limitations period should have been applied to his outstanding liabilities for the other tax years first, and the remaining balance treated as paid within the one-year period. Had this been done, the FTB could have refunded over $5,700 to the taxpayer.

Example of overpayment application and SOL: The following illustrates the issues in this case (figures are rounded):

- Total overpayment: $13,500
- Amount paid prior to one-year limitations period: $6,000
- Amount paid within one-year limitations period: $7,500
- Amount owed for 2004, 2007, 2010: $7,800

If the FTB had applied the $6,000 paid prior to the one-year statute of limitations period to the outstanding liabilities for the other tax years, the FTB could have refunded $5,700 to the taxpayer. This would have been the amount available in his account ($7,500 + [$6,000 - $7,800]).

But because the FTB could only apply the $7,500 of tax collected within the last year to the other outstanding liabilities, there was no money remaining in the taxpayer's account that was attributable to the prior year that could be refunded to the taxpayer.

Discretionary authority

Although the OTA decision did not address this issue, the FTB, like the IRS, is given wide discretion in how it applies tax payments and applies payments to any balances due prior to issuing a refund, usually to the oldest liability first.[3]

[1] *Appeal of Fowzer* (April 17, 2018) 2018-OTA-026

[2] R&TC §19306

[3] R&TC §19301

Clients with LLCs moving out of California

Don't forget about the LLC fee.

By Renée Rodda, J.D.
Editor

With more businesses moving out of California, we continue to get questions about how much California tax those entities will pay after leaving. With LLCs, that question is a little more complicated because in addition to potential income tax, these entities are also subject to an annual fee.

If the entity still has sales that are sourced to California, those sales could result in an LLC fee liability.

LLC fee

An LLC (that is not taxed as a corporation) with California-source total income in excess of $250,000 must pay an annual fee.[1] The fee is in addition to the $800 annual tax for entities registered or doing business in California.

LLC Annual Fee Chart

Total income level	Fee based on California income
$250,000–$499,999	$900
$500,000–$999,999	$2,500
$1,000,000–$4,999,999	$6,000
$5,000,000 or more	$11,790
The fee is permanently set under R&TC §17942 and will remain the same in subsequent years unless specifically changed by the Legislature.	

The LLC fee is based on income derived from activity in California rather than on worldwide income.[2]

Total California-source income is defined as "gross income" plus "costs of goods sold" (COGS). For taxpayers with COGS, "gross income" as used in R&TC §17942 is akin to "gross profit" in the standard accounting presentation. For example:

Sales	$50,000
Costs of goods sold	(10,000)
Gross profit	$40,000

As such, taxpayers who sell products should add gross profit to COGS. Thus, the total income is $50,000 ($40,000 + $10,000). To that they must add other revenues, such as interest, dividends, and rents.

Also included are capital gains (not losses) and IRC §1231 gains (not losses). Under IRC §61(a)(3), the gains and losses are never netted. For example, if an LLC sells two stocks, one at a $20 gain and one at a $2 loss, it would include $20 (not $18) of capital gain in the calculation of total income.[3]

Income from the passive holding of intangible property, income from occasional or isolated sales, and expense reimbursements are included in total income also.[4]

The total income attributable to California is determined by utilizing the single sales factor apportionment formula and the market-based sourcing sales factor rules contained in R&TC §§25135 and 25136, and the regulations under these sections (as modified by the regulations under R&TC §25137, if applicable), other than those provisions that exclude receipts from the sales factor.

Let's review different types of "sales" to see how that income is sourced.

Services

Services are assigned to the location where the purchaser of the service receives the benefit of the service.

Example of services: Mabel Lein, LLC, is a makeup company. Mabel, the managing member, works for various performers throughout the country. She has no employees, and all work for the company is performed by Mabel. During the taxable year, she worked 1,000 hours doing makeup for her clients (800 hours in New York and 200 hours in California). Of her total income, 20% is attributable to California. The hours she spent negotiating her contracts with her clients do not count.

Real property

Total income from the sale, rental, leasing, licensing, or other use of real property is attributable to California if the real property is located in California.

If a rental property has interest income that is related to bank deposits for the rental property, we do not believe that income is from California, especially if the bank account is not located in California.

Real estate dealers

In FTB Legal Ruling 2016-01, the FTB stated that for purposes of the LLC fee, if property is held for investment purposes, the property's adjusted basis is not included in the taxpayer's gross income. However, if the property is sold in the taxpayer's ordinary course of business, the adjusted basis must be added back to the taxpayer's gross income for purposes of calculating the taxpayer's LLC fee.

This means that real estate dealers would be required to include the total income from a sale of their property in their fee calculation.

> **Example of a real estate dealer:** Flipper, LLC, considered a real estate dealer for this example, purchases a California residence for $300,000 and makes $150,000 in improvements. When the improvements were complete, the LLC sold the home for $700,000.
>
> Flipper has $700,000 of California income for purposes of the LLC fee because his basis must be added back in.
>
> At the same time, Skip, who is not a real estate dealer, uses his single-member LLC to invest in a piece of California real estate at a cost of $500,000. He makes $100,000 in improvements before he sells the property for $800,000.
>
> Skip's California income for purposes of the fee is $200,000 because he is not required to add his basis back in.
>
> Based on $700,000 in California total income, Flipper must pay a $2,500 LLC fee. In contrast, because Skip has less than $250,000 in California total income, Skip is not required to pay an LLC fee.

Tangible personal property

If tangible personal property is located within and outside California during the rental, lease, or licensing period, the total income attributable to California is measured by the ratio of the time the property was physically present or was used within California to the total time or use of the property during that period.

> **Example of a real estate dealer:** Flipper, LLC, considered a real estate dealer for this example, purchases a California residence for $300,000 and makes $150,000 in improvements. When the improvements were complete, the LLC sold the home for $700,000.
>
> Flipper has $700,000 of California income for purposes of the LLC fee because his basis must be added back in.
>
> At the same time, Skip, who is not a real estate dealer, uses his single-member LLC to invest in a piece of California real estate at a cost of $500,000. He makes $100,000 in improvements before he sells the property for $800,000.
>
> Skip's California income for purposes of the fee is $200,000 because he is not required to add his basis back in.
>
> Based on $700,000 in California total income, Flipper must pay a $2,500 LLC fee. In contrast, because Skip has less than $250,000 in California total income, Skip is not required to pay an LLC fee.

[1] R&TC §17942

[2] R&TC §17942(b)

[3] R&TC §17071

[4] 18 Cal. Code Regs. §17942

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2018 ballot initiatives of interest

Repeal of the gas tax and enhanced property tax transfers will go to the voters.

By Kathryn Zdan, EA
Contributing Editor

There are several interesting initiatives appearing on the ballot this November.

Property tax transfers

Proposition 5 would amend Proposition 13 to allow homebuyers who are age 55 or older or severely disabled to transfer their property tax assessed value, with a possible adjustment, from their prior home to their new home, regardless of:

- The new home's market value;
- The new home's location in the state; or
- The buyer's number of moves.

Under current law, homebuyers over 55 years of age are eligible to transfer their property tax assessments from their prior home to their new home if the new home's market value is equal to or less than the prior home's value. However, this value transfer is available only once in a taxpayer's lifetime, and the counties, rather than the state, decide whether tax assessments can be transferred across county lines.

Gas tax repeal

Proposition 6 would repeal the gas tax enacted in 2017 under SB 1 (Ch. 17-5). Future fuel tax impositions, increases, and extensions would also need to be approved by voters.

SB 1 increased the gas tax by $0.12 per gallon, increased the diesel fuel tax by $0.20 per gallon, increased the sales tax on diesel fuels by an additional 4 percentage points, created an annual transportation improvement fee, and created an annual zero-emission vehicles fee. Proposition 69, which was approved by voters on the June 2018 ballot, expanded the mandate that revenue from these taxes and fees be spent on transportation-related purposes.

Daylight savings time

Proposition 7 is tied to the recent passage of AB 807 (Ch. 18-60) and would establish permanent, year-round daylight saving time (DST) in California. AB 807 certified the measure for the election in November.

However, permanent daylight savings time would require federal approval. As of 2018, the Uniform Time Act allows states to adopt one of two options:

- Adopt DST between the second Sunday of March and the first Sunday of November; or
- Remain on standard time all year.

In 2016, the California State Legislature asked the President and Congress to pass an act that would allow California to adopt year-round DST. Florida made the same request in 2018.

Three Californias won't be on the ballot

Proposition 9, which would have proposed dividing California into three states: California, Northern California, and Southern California, will not be on the ballot. The California Supreme Court issued an order stating that "significant questions have been raised regarding the proposition's validity."

You can see all of the initiatives that will appear on the November ballot at:

https://ballotpedia.org/California_2018_ballot_propositions

Upcoming due dates

- Extended due date for S corporation (Form 100S) returns
- Form 592, Quarterly Resident and Nonresident Withholding Statement, and payments due (Form 592-V)
- 592-A, Payment Voucher for Foreign Partner or Member Withholding, along with quarterly payment

THUMB TAX

FTB releases communication guidelines — In December 2017, the three-member Franchise Tax Board adopted Resolution 2017-01 limiting *ex parte* communications between petitioners, their representatives, FTB staff, and board members pending an appeal of a petition under 18 Cal. Code Regs. §25137 (pertaining to apportionment).

Guidelines regarding this resolution were recently released, which outline:

- The general process for a §25137 petition and the application of Resolution 2017-01;
- The definition of *ex parte* communication;
- When communication between the parties listed in the resolution is permitted; and
- Recording any *ex parte* communications that inadvertently occur.

The resolution and guidelines can be viewed at:

www.ftb.ca.gov/law/meetings/12072017/Resolution.pdf

www.ftb.ca.gov/law/regs/25137/06192018-Ex-Parte-Guidelines.pdf

Relief available for employers affected by wildfires — Employers affected by the wildfires listed below may request up to a 60-day extension of time from the EDD to file their state payroll reports and/or deposit state payroll taxes without penalty or interest. Written requests for extension must be received within 60 days from the original delinquent date of the payment or return to file/pay.

- Lake County: Pawnee Fire
- Siskiyou County: Klamathon Fire
- San Diego County: West Fire
- Santa Barbara County: Holiday Fire

More information from the EDD can be found at:

www.edd.ca.gov/Payroll_Taxes/Emergency_and_Disaster_Assistance_for_Employers.htm

New film and television tax credit — Under the provisions of SB 871 (Ch. 18-54), California provides a new Film and Television Production Tax Credit for tax years beginning January 1, 2020, through July 1, 2025. The current film and television credit expires in 2020.

The credit amount is either 20% or 25% of qualified expenditures for the production of a qualified motion picture in California, and the bill contains provisions for increased credit amounts for taxpayers that meet certain conditions.

Details on SB 871 can be found at:

http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB871

FTB interest rates for the first half of 2019 — The FTB has released the interest rates for the period January 1, 2019, through June 30, 2019.

The adjusted interest rate for personal tax underpayments/overpayments and corporate underpayments is 5% per year (increased from 4% for the period July 1, 2018, through December 31, 2018). This is the rate compounded daily that accrues with respect to various state taxes, including personal income, corporate income, and franchise tax.

The rate for corporate tax overpayments is 2% per year (increased from 1% for the period July 1, 2018, through December 31, 2018).

EDD announces new electronic payment options for employers — Employers no longer need to create an account on the EDD website to make an electronic payment. Electronic payroll tax payments can now be made using Express Pay, which allows employers to make a payment by entering their account number or letter ID without logging in to an account. Employers can also now make garnishment payments, view earnings withholding orders (EWOs), and view a list of active employees with EWOs through their e-Services for business account.[1]

[1] EDD Tax Branch News #375 (July 3, 2018)

2018/19 collection and filing enforcement cost recovery fees set — For the 2018/19 fiscal year, the updated fee amounts are:[2]

- Bank and corporation filing enforcement fee: $81 (down from $85);
- Bank and corporation collection fee: $382 (up from $374);
- Personal income tax filing enforcement fee: $88 (up from $84); and
- Personal income tax collection fee: $317 (up from $287).

[2] SB 840 (Ch. 18-29); R&TC §19254

Taxpayer could not force Costco to seek refund of tax paid on Ensure — Is Ensure an exempt food or a taxable nutritional supplement? That was at the heart of a recent case in which the court ruled that a taxpayer could not bring a court action to compel Costco to seek refunds of sales tax paid on its sales of Ensure.[3] The courts will only allow ultimate customers to compel retailers to seek refunds under limited circumstances.[4] One requirement is that the BOE make a "precursor" determination that a refund is actually due.

Prior to 2002, the Board had determined that sales of Ensure were nontaxable food products. But in 2002, the Ensure label was changed to state that it was a nutritional supplement, and therefore the Board determined that the sales were taxable. In 2006 the label was changed yet again to remove the supplement description, and therefore BOE staff determined that such sales were exempt food products.

However, the court ruled that an informal chief counsel opinion, an e-mail from an auditor, and an article in the BOE's Tax Bulletin stating that sales of Ensure were exempt did not qualify as a "precursor" determination that a refund was actually due.

[3] *Littlejohn v. Costco Wholesale Corp.* (July 13, 2018) Cal. Ct. App, 1st App. Dist, Case No. A144440

[4] *Javor v. State Board of Equalization* (1974) 12 Cal.3d 790; *Decorative Carpets, Inc. v. State Board of Equalization* (1962) 58 Cal.2d 252; *McClain v. Sav-on Drugs* (2017) 9 Cal.App.5th 684

Class action allowed for LLC fee refund case

A California court of appeal has ruled that an action brought against the FTB on behalf of taxpayers that filed LLC fee protective refund claims for pre-2007 tax years can be certified as a class action.[1]

Remember the ***Bakersfield Mall*** and ***Centerside II*** LLC fee cases? These were the LLC fee refund cases that were filed back in 2007 and 2010 after two California appellate courts ruled that California's LLC fee, which was previously computed on an LLC's worldwide income, was unconstitutional.

While the FTB had previously fully or partially refunded fees from LLCs who only had income from outside California, and those taxpayers who had income from both inside and outside California, no fees have been refunded to those LLCs whose income was solely from California sources. With the class certified, the taxpayers can now argue their case that because the LLC fee law was unconstitutional as written, all LLC fee refund claims should be granted.

Any potential refunds are limited to those taxpayers who filed timely refund claims for pre-2007 tax years. This means you can't file refund claims now based on this case. Only taxpayers who filed refund claims before the statute of limitations for the pre-2007 years would qualify for refunds. However, the court's decision is a major victory for taxpayers because this is the first tax refund case that has been certified for a class action in decades.

We anticipate that the FTB will appeal this decision, so things are far from settled. If and when the class action proceeds, notices will likely be sent to taxpayers who had filed refund claims giving them an opportunity to "opt-in" to the class action. We will keep you posted as the case develops.

For more information on these pre-2007 refund claims, see "LLC fee refunds coming: Notify FTB by August 20" in the June 2009 issue of *Spidell's California Taxletter®*.

[1] ***Franchise Tax Boward Limited Liability Corporation Tax Refund Cases*** (July 18, 2018) Cal. Ct. App., 1st App. Dist., Case No A140518

CALIFORNIA CONTACTS

A table of a summary of each state's current nexus laws is available at:	www.caltax.com/spidellweb/public/editorial/CAT/0818CAT-nexuschart.pdf
To see all of the initiatives that will appear on the November ballot, go to:	https://ballotpedia.org/California_2018_ballot_propositions
The FTB adopted Resolution 2017-01 and guidelines can be viewed at:	www.ftb.ca.gov/law/meetings/12072017/Resolution.pdf www.ftb.ca.gov/law/regs/25137/06192018-Ex-Parte-Guidelines.pdf
Information on relief available for employers affected by wildfires can be found at:	www.edd.ca.gov/Payroll_Taxes/Emergency_and_Disaster_Assistance_for_Employers.htm
Details on SB 871 can be found at:	http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB871