CALIFORNIA STATE LEGISLATURE

REVENUE AND TAXATION REFERENCE BOOK

2013

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PREFACE

This Revenue and Taxation Reference Book is designed to answer some of the more commonly asked questions about California's tax structure. It is written with the general public in mind and gives a broad overview of most of California's major taxes, as well as summaries of some special features of the tax system. Many of the technical features and fine points of the law are excluded in an attempt to keep the material accessible to lay readers.

This Reference Book reflects California's tax law as of December, 2013. Generally, tax provisions that expired or were repealed prior to that date are not described.

Many features of the state tax system are described more than once in this Reference Book. For instance, certain income tax provisions affecting businesses are described both as a feature of the Personal Income Tax in Chapter 2B and in Chapter 2C, under the Corporation Tax. Readers should watch for cross-references within the text.

The Glossary in Chapter 8 provides short definitions of over 200 terms and acronyms commonly used in tax discussions.

Thanks are due to the staff members of the Franchise Tax Board, the Board of Equalization, and other executive agencies who provided information, advice, and editorial comment during the preparation of this book. Legislative Counsel also provided assistance on various issues in this book. Their collective assistance ensures that the information included is both timely and accurate.

The Revenue and Taxation Reference Book has been prepared and maintained over the years by the staff of the Assembly Committee on Revenue and Taxation.

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GENERAL FUND REVENUES, FISCAL YEAR 2013-14
(Dollars in Millions)

Tax	Total Revenue	Percentage of General Fund Budget
Personal Income Tax	$ 66,522	64.20%
Retail Sales and Use Tax (General Fund portion)	$ 22,759	22.90%
Corporation Tax	$ 8,107	8.00%
Highway Users Tax	$ 0	0.00%
Motor Vehicles License Fees	$ 19	0.20%
Insurance Tax	$ 2,287	2.10%
Estate Tax	$ 0	0.00%
Liquor Tax	$ 350	0.35%
Cigarette Tax (General Fund portion)	$ 89	0.09%
Other	$ 2,054	2.40%
TOTAL	$100,147	100.00%*

*May not total 100% due to rounding error.

Source: Governor's 2014-15 Budget Summary, General Fund Revenue Sources, Figure SUM-04; Appendix 14, Schedule 8 (Comparative Statement of Revenues)

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OVERVIEW OF TAX AGENCIES

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- Legislative Vote Requirements
- Constitutional Amendments and Statutory Initiatives
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- Effective Dates and Operative Dates

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1. INTRODUCTION

This chapter summarizes the most important constitutional, statutory, and legislative provisions that apply to tax legislation.

2. "TAX LEVY" BILLS

Tax Levy Bills Defined. A tax levy is a bill that imposes a state tax, repeals a state tax, or otherwise changes in any material way the rate, base, or burden of a state tax. For this reason, many bills that deal with taxes are designated as tax levy bills.

The Office of Legislative Counsel (Legislative Counsel), which is responsible for drafting all bills introduced and amended in the Legislature, determines whether a bill is a tax levy.

Legislative Counsel will classify a bill as a tax levy if its subject matter exclusively or principally imposes, repeals, or otherwise modifies the incidence or burden of a state tax. After determining that a bill is a tax levy, Legislative Counsel will include in the title of the bill a phrase indicating that the bill is a tax levy. The body of the bill will also contain a statement that the measure is a tax levy.

Bills that impose, repeal, or modify a state tax and that also contain unrelated provisions are not designated as tax levies, unless Legislative Counsel determines that the tax levy provisions are the principal or primary purpose of the bill.

Bills that exclusively or primarily affect the rate, base, or burden of the property tax are also designated as tax levies. However, a bill that only authorizes a local government to propose a tax to the voters is not a tax levy, because that bill does not directly affect the rate, base, or burden of an existing local tax.

Bills that deal exclusively or principally with tax administration, including the imposition of penalties and interest, are not tax levies.

How Tax Levy Bills Are Treated. The Legislature treats tax levy bills differently from other bills in the following ways:

- Tax levy bills take effect immediately [California Constitution, Article IV, Section 8(c)(3).] However, their operative dates may be different (see Section 7, below).

- Tax levy bills are not subject to referendum by the people [California Constitution, Article II, Section 9(a).]

- Tax levy bills are not subject to many of the normal legislative deadlines for the consideration of bills. Instead, they are treated like urgency bills and Constitutional Amendments. Accordingly, policy and fiscal committees may meet to hear a tax levy bill at any time other than during those periods when no committee may meet for any purpose. Similarly, either house may meet for the purpose of considering and passing a tax levy bill at any time during the legislative session.

3. LEGISLATIVE VOTE REQUIREMENTS FOR TAX BILLS

The California Constitution establishes legislative vote requirements for all tax bills, including tax levies.

Bills requiring a two-thirds vote are those that:

- Result in any taxpayer paying a higher tax (California Constitution, Article XIIIA, Section 3);

- Contain an urgency clause [California Constitution, Article IV, Section 8(d)];

- Classify personal property for differential taxation or that exempt personal property from taxation (California Constitution, Article XIII, Section 2);

- Contain a General Fund appropriation for any purpose other than public education, unless passed as part of the budget [California Constitution, Article IV, Section 12(d)];

- Override a Governor's veto [California Constitution, Article IV, Section 10(a).]; and

- Amend the provisions of the California Children and Families First Act of 1998, an initiative constitutional amendment and statute passed as Proposition 10 by the voters in November 1998 (Proposition 10, 1998, Section 8).

Bills that amend any portion of the Cigarette and Tobacco Products Tax Law enacted in November 1988 by the voters as Proposition 99 require a <u>four-fifths</u> vote.

With certain limited exceptions, all other tax bills require a <u>majority</u> vote.

4. CONSTITUTIONAL AMENDMENTS AND STATUTORY INITIATIVES

Some aspects of state tax law cannot be changed by the Legislature. These instances and the procedures relating to them are outlined below.

Tax Law Set Forth in the Constitution. A constitutional amendment is required to change any tax law contained in the California Constitution. Proposed constitutional amendments may be placed on the statewide ballot either by the Legislature or by the people through an initiative. Constitutional amendments proposed by the Legislature must be adopted by a two-thirds vote of each house and do not require the Governor's signature. An initiative, in turn, requires a majority vote of the people.

Initiative constitutional amendments must receive valid signatures equal to at least 8% of the number of voters who voted in the last gubernatorial election in order to be placed on the ballot.

Statutory Tax Law Enacted by the Voters Through a Statutory Initiative. In general, an initiative tax statute can only be changed by a vote of the people on another statewide ballot. The proposed change in the law may be placed on the ballot by another initiative or by a bill enacted by the Legislature.

Some initiative statutes, however, contain language that allows the Legislature to make changes without voter approval. These statutes typically identify the types of changes allowed and specify the legislative vote requirement to amend the statute.

Initiative statutes must receive valid signatures equal to at least 5% of the number of voters who voted in the last gubernatorial election in order to be placed on the ballot.

5. BILLS WITH STATE MANDATES ON LOCAL AGENCIES

The California Constitution (California Constitution, Article XIIIB, Section 6) requires the state to reimburse local governments for any costs incurred when the state mandates

local government to provide certain new programs or higher levels of service. The Constitution provides that reimbursement is permissible but not required for mandates requested by the local agency affected, legislation defining a new crime or changing an existing definition of a crime or for mandates enacted before January 1, 1975. Reimbursement is not provided if the mandates are self-financing, have offsetting savings, require no new duties, or if the new duties result from a ballot measure approved by the voters. Government Code Sections 17500-17630 provide procedures for the constitutionally required state reimbursement of mandated local costs.

In addition, statutes require reimbursement to local agencies in the following two cases:

- Enactment of property tax exemptions or new classifications of exempt property (Revenue and Taxation Code Section 2229); or,
- Enactment of sales and use tax exemptions that cause a new loss of revenue (Revenue and Taxation Code Section 2230).

Constitutional requirements for reimbursement cannot be waived. Statutory requirements for reimbursement may be waived by statute, including the statute creating a new exemption.

6. HEARINGS BY LEGISLATIVE COMMITTEES

Bills materially changing the Revenue and Taxation Code (whether by amendment, addition or deletion) are generally referred to the Assembly Committee on Revenue and Taxation and the Senate Committee on Governance and Finance for policy review.

Under current legislative rules, tax bills, like other bills, must be referred to the Appropriations Committee of each house if they do any of the following:

- Appropriate money;
- Result in a substantial expenditure of state money by imposing new responsibilities on the state, imposing new or additional duties on state agencies, or liberalizing any state program, function, or responsibility;
- Result in a substantial gain or loss of revenue to the state; or,

- Result in a substantial reduction of expenditures by reducing, transferring, or eliminating any existing responsibilities of any state agency, program, or function.

7. EFFECTIVE DATES AND OPERATIVE DATES

In order to become law, tax bills, like all bills, must be passed by both houses of the Legislature and signed by the Governor, allowed to become law without the Governor's signature, or passed over the Governor's veto [California Constitution, Article IV, Sections 8(b) and 10(a).]

The effective date of a bill is the date it becomes law. Tax levy bills, urgency bills, bills calling for an election, and bills making appropriations for the usual current expenses of California go into effect immediately upon enactment [California Constitution, Article IV, Section 8(c)(3).] Bills that do not take immediate effect (i.e., bills that are not tax levies or urgency measures or that do not call for an election or make an appropriation) take effect on January 1 following enactment [California Constitution, Article IV, Section 8(c)(1).]

For most tax bills, the effective date of a bill that takes immediate effect is the day the statute is chaptered by the Secretary of State. However, unless specified otherwise, personal income tax and corporation tax bills apply to taxable years beginning on or after the January 1 preceding enactment (Revenue and Taxation Code Sections 17034, 18415, and 23058). For example, a bill enacting an income tax credit that is chaptered by the Secretary of State during 2010 will apply to taxable years beginning on and after January 1, 2010, unless otherwise specified.

Furthermore, bills may specify an operative date that is different from the effective date of a bill. For example:

- Bills amending the Sales and Use Tax Law will often specify as an operative date the first day of the first calendar quarter beginning more than 90 days after a bill's effective date;

- Personal income and corporation tax bills sometimes specify an operative date beginning in a different taxable year than the one in which the bill is enacted; or,

- Any type of bill (whether or not it is tax-related) may specify another operative date. A bill's operative date is sometimes pushed back in time in order to delay its revenue impact or to allow both taxpayers and the agency charged with administration more time to prepare.

Bills enacted in special sessions of the Legislature have different rules governing passage and effective dates.

CHAPTER 1B
BASIC FACTS ABOUT TAX LEGISLATION

CHAPTER 1C

RESTRICTIONS ON THE TAXING POWER OF THE LEGISLATURE

HIGHLIGHTS

- California Constitutional Restrictions
- U.S. Constitutional Restrictions
- State Appropriations Limit
- Initiative Statutes
- Tax Increases
- Governor's Veto
- Limits on Local Government Taxing Authority

1. INTRODUCTION

While the Legislature has broad powers to impose taxes, there are a number of restrictions on this power. The U.S. Constitution restricts the Legislature's ability to impose taxes. Other factors also constrain the Legislature's ability to impose taxes, as described below.

2. CALIFORNIA CONSTITUTIONAL RESTRICTIONS

A number of features of California's tax law are established in the California Constitution. Modification or repeal of many of these features must be accomplished by a constitutional amendment approved by the voters of the state. The major constitutional provisions governing the power of taxation are described below.

General Taxes Not Subject to Referendum. Section 9 of Article II states that statutes providing for tax levies or appropriations for the usual current expenses of California are not subject to referendum.

Vehicle License Fees Reserved for Cities and Counties. Section 15 of Article XI requires all revenues derived from that portion of the Vehicle License Fee rate that does not exceed 0.65% of the fair market value of the vehicle to be allocated to cities and counties.

Uniform Property Taxation. Section 1 of Article XIII specifies that all property is taxable and must be assessed and taxed at full market value. This provision is modified by the restrictions upon reassessment contained in Article XIIIA.

The State May Authorize, But Not Impose, Local Taxes. Section 24 of Article XIII specifies that the state may not impose taxes for local purposes, but may authorize local governments to impose them.

Insurers Are Exempt From Most Taxes. Section 28 of Article XIII exempts insurance companies or associations from all taxes other than the state insurance gross premiums tax, local property taxes, and motor vehicles fees. Only the rate of the gross premiums tax may be changed by the Legislature. (See Chapter 3C of this Reference Book for more information on the Insurance Gross Premiums Tax.)

Local Tax Sharing Requires Voter Approval. Section 29 of Article XIII requires any agreement to share sales or use tax revenues between local jurisdictions to receive majority voter approval.

Sales Tax for Public Safety. Section 35 of Article XIII, approved by the voters in November of 1993, imposes a 1/2 cent sales and use tax statewide with the revenues allocated to cities and counties to fund public safety services.

Property Tax Rate Limited. Section 1 of Article XIIIA (Proposition 13) limits ad valorem property tax revenues to 1% of full cash value. Section 2 of Article XIIIA defines full cash value and provides that property shall only be reassessed when it changes ownership. No state transaction taxes or real estate taxes may be imposed.

Vote Requirement for State Taxes. Section 3 of Article XIIIA provides that increases in state taxes must be approved by a two-thirds vote of both houses of the Legislature and prohibits imposition of new ad valorem property taxes or state transaction taxes.

Two-Thirds Vote for Local Special Taxes. Section 4 of Article XIIIA requires cities, counties, and special districts to receive two-thirds voter approval in order to impose a "special" tax (see below). Section 2(d) of Article XIIIC provides that no local government may impose, extend, or increase any special tax unless it is approved by a two-thirds vote of the electorate.

No Gifts of Public Funds. Section 6 of Article XVI prohibits the Legislature from making gifts or loans of public moneys. The interpretation of this prohibition constrains the Legislature from providing retroactive tax relief.

Redevelopment Areas. Section 16 of Article XVI specifies that an "increment" of tax revenues generated in a redevelopment area shall be allocated to redevelopment activities.

Use of Fuel Tax Revenues. Article XIX requires revenues from fuel taxes to be used for specified transportation-related purposes. (See Chapter 3E for more information on Fuel Taxes.)

3. U.S. CONSTITUTIONAL RESTRICTIONS

Some restrictions in the U.S. Constitution, which California adopted as a condition to admittance into the Union, further limit the power of the Legislature to tax.

For example, the state may not tax the U.S. government or its instrumentalities. The state is also prohibited from taxing imports or exports and from imposing taxes that violate either the Due Process Clause or the Commerce Clause.

4. STATE APPROPRIATIONS LIMIT

The California Constitution (Article XIIIB) imposes an indirect constraint on the level of taxation in the state by way of an appropriations limit.

Under Article XIIIB, most spending by the state from tax proceeds is subject to an annual appropriations limit. The limit is expressed as the level of its **appropriations** in the base year (1986-87), with annual adjustments for changes in population and California's cost-of-living, as defined. Revenues collected that exceed this limit over a two-year period are divided between K-14 programs and rebates to taxpayers.

Proposition 111, approved by the voters in June 1990, substantially modified the provisions of the Article XIIIB appropriations limit. See Chapter 5 of this Reference Book for a detailed discussion of the existing appropriations limit.

5. INITIATIVE STATUTES

Generally, statutory tax law adopted by the voters through the initiative process may not be changed by the Legislature. Unless otherwise provided in the initiative statute, laws adopted through the initiative process may only be changed by a vote of the people. Amendments may be achieved through popular vote on one of the following two types of measures: (a) another initiative that is qualified for the ballot by the people, or (b) a bill that is passed by the Legislature and subsequently placed on the statewide ballot.

Examples of state tax laws adopted by initiative include:

- Repeal of the state inheritance tax (Proposition 6 of June 1982);
- Requirement to index personal income tax brackets (Proposition 7 of June 1982);
- Establishment of the state lottery, and provisions that sales of lottery tickets are exempt from state sales taxes and that lottery winnings are exempt from state income taxes (Proposition 37 of November 1984);
- Increase in cigarette taxes and imposition of tobacco taxes and use of surtax revenues for treatment and research of tobacco-related diseases; school and community health education programs (Proposition 99 of November 1988);
- Increase in state motor vehicle fuel taxes (Proposition 111 of June 1990);
- Increase in cigarette and tobacco taxes and use of funds for early childhood development and smoking prevention programs (Proposition 10 of November 1998);
- Requirements to use the revenues derived from sales taxes on gasoline purchases for transportation purposes instead of depositing the revenues into the General Fund (Proposition 42 of March 2002);
- Imposition of a 1% surtax on taxable incomes in excess of $1 million and use of funds for mental health services (Proposition 63 of November 2004);
- Requirement for multistate business to utilize a "single sales factor" apportionment formula for determining their taxable income in California. (Proposition 39 of November 2012).

Some initiative statutes (e.g., Proposition 99) contain language specifying the types of changes the Legislature may make by statute and the vote requirements applicable to those changes.

6. VOTE REQUIREMENTS FOR TAX INCREASES

California is one of 16 states that require super-majority votes of the Legislature on tax increases. As noted in Chapter 1B, any change in state statute that results in any taxpayer paying a higher tax must be passed by a two-thirds vote of each house of the Legislature (Article XIIIA, Section 3, as amended by Proposition 26, November 2, 2010).

7. GOVERNOR'S VETO

In order to become law, bills must be passed by both houses of the Legislature and signed by the Governor or allowed to become law without the Governor's signature. If the Governor vetoes a bill, it may become law if the veto is overridden by a two-thirds vote of each house of the Legislature.

8. LIMITS ON LOCAL GOVERNMENT TAXING AUTHORITY

Four voter-approved initiatives limit the power of local government to impose taxes for local purposes.

Proposition 13 (California Constitution, Article XIIIA approved by the voters in 1978) limits the ability of local governments to impose special taxes. Under Proposition 13, cities, counties, and schools must receive two-thirds voter approval before imposing a "special tax". Local jurisdictions are prohibited from imposing property tax rates above 1%, except for specified rates for debt service. Proposition 13 did not, however, define what constitutes a "special" tax.

Proposition 26, (California Constitution, Article XIIIA and Article XIIIC approved by the voters in 2010) broadens the definition of state and local taxes to include any change in state statute that results in any taxpayer paying a higher tax. This proposition also imposes an additional requirement for voters to approve local levies and charges with limited exceptions.

Proposition 62, a statutory initiative approved by the voters in 1986, prevents the imposition of new general taxes by local agencies without voter approval. However, because Proposition 62 was a statutory, rather than a constitutional initiative, it did not restrict charter law cities' right to impose general taxes without a vote or prevail over any contradictory constitutional provisions. Appellate courts found Proposition 62's voter approval requirements for general taxes unconstitutional. In 1995, however, the California Supreme Court reversed earlier lower court decisions and found Proposition 62 constitutional.

Proposition 218 (California Constitution, Articles XIIIC and XIIID approved by the voters in 1996) requires a majority vote of the people in order to approve the imposition or increase of a general tax. In addition, it provides that any general tax imposed, extended, or increased after January 1, 1995, and before the effective date of Proposition 218, shall continue to be imposed only if approved by a majority vote of the people.

It further provides that no local government may impose, extend, or increase any special tax unless approved by a two-thirds vote. In addition, it provides that a special tax means "any tax imposed for specific purposes, including a tax imposed for specific purposes which is placed into a general fund". Proposition 218 also provides that special purpose districts or agencies, including school districts, have no power to levy general taxes.

Proposition 218 established procedures and requirements for all assessments for special benefits. No assessment may be imposed on any parcel that exceeds the reasonable cost of the proportional special benefit conferred to that parcel. Further, the assessment may not be imposed if there is a majority protest. In general, a majority protest exists if the number of ballots submitted in opposition to the assessment exceed the number of ballots submitted in support to the assessment.

Proposition 218 requires a majority vote of property owners or a two-thirds vote of the electorate to impose or increase a property-related fee for any service other than water, sewer or refuse collection. It further specifies that no property-related fee may be:

- Levied to pay for a general governmental service, such as police or fire service;
- Imposed for a service not used by the property owner; or,
- Used to finance programs unrelated to the property-related services.

9. LIMITS ON STATE INVOLVEMENT IN LOCAL TAXATION

Proposition 1A (California Constitution, Articles XI, XIII, and XIIIB, approved by the voters in 2004) significantly reduced the state's authority over major local government revenue sources and requires the state to reimburse local governments for future revenue shifts approved at the state level. Among its many provisions, Proposition 1A prohibits the state from:

- Reducing any local sales tax rate;
- Limiting a local government's authority to levy a sales tax rate;
- Changing the allocation of local sales tax revenue;
- Shifting property tax revenues from local governments to schools or community colleges, over and above those shifts in effect prior to November 3, 2004;
- Reducing the property tax revenues provided to cities and counties as part of the so-called "triple-flip", an arrangement in which the state shifted property tax revenues for sales tax revenues and pledged the sales tax revenue to pay off deficit bonds approved by voters in March 2004.

Under Proposition 1A, any decision by the state to lower the Vehicle License Fee rate below the rate in effect on November 3, 2004, must be accompanied by a pledge to provide local governments with equal replacement revenues. Additionally, any change in how property tax revenues are shared among local governments within a county must be approved by two-thirds of both houses of the Legislature (prior law allowed such changes to be approved with a majority vote).

Proposition 1A does provide one major exception to its provisions. Beginning in 2008-09, the state may shift a limited amount of property tax revenue from local governments to schools for one fiscal year, provided that (1) the Governor declares that the shift is needed due to a severe state financial hardship, (2) the Legislature approves the shift with a two-thirds vote of both houses, and (3) the money is repaid with interest within three years. Shifts such as the one just described may not be performed more than twice during any 10 consecutive fiscal years.

Sales and Property Tax Swap – the "Triple Flip". The Legislature passed the 2003-04 Budget package with a specific feature to finance the deficit financing bonds. To facilitate repayment, sales tax revenues were swapped for property tax revenues. This three-step method, known as the "triple flip", contains the following:

1) Redirecting one-quarter of 1% of the local sales tax revenue to the state to repay the deficit reduction bonds. This temporary measure began in fiscal year 2004-05;

2) Offsetting the loss of local sales tax revenues by redirecting an equal amount of property taxes to cities and counties from the Educational Revenue Augmentation Fund (ERAF); and

3) Increasing state education apportionment to replace K-14 revenue losses related to redirected ERAF monies.

CHAPTER 1C
RESTRICTIONS ON THE TAXING POWER OF THE LEGISLATURE

CHAPTER 1D

WHERE TO GET INFORMATION ABOUT STATE TAXES

AGENCY	*TAX*
Board of Equalization (BOE) Check local phone directory for district office or call the toll-free statewide number of (800) 400-7115 or log on to www.boe.ca.gov California Relay Service (CRS): 711 (for hearing and speech disabilities) Call County Assessor for inquiries regarding local property taxes.	Sales and Use Property Alcoholic Beverage Cigarette Emergency Telephone Users Surcharge Energy Resources Surcharge Hazardous Substances Insurance Motor Vehicle Fuel Diesel Fuel Use Fuel Timber Yield
Franchise Tax Board (FTB) (800) 852-5711 (800) 822-6268 (Hearing Impaired) (800) 852-2753 Or log on to: www.ftb.ca.gov For calls outside the United States: (916) 845-6500 Taxpayer Advocate (916) 845-4300	Personal Income Tax Corporation Tax

AGENCY	*TAX*
Department of Motor Vehicles (DMV) (800) 777-0133 Or log on to: www.dmv.ca.gov	Motor Vehicle Fees: License (VLF), Registration, and Weight Use Tax on Vehicles
Department of Insurance (800) 927-4357 Los Angeles Area (213) 897-8921	Insurance: Gross Premiums Tax
(916) 325-3800 or log on to: www.insurance.ca.gov	California Earthquake Authority
Employment Development Department (EDD) For employment tax information, log on to EDD's Web site at www.edd.ca.gov or contact: Taxpayer Assistance Center (888) 745-3886	Unemployment Insurance (UI) Employment Training Tax (ETT) State Disability Insurance (SDI) Withheld Personal Income Tax (PIT)
State Controller's Office For Estate Tax information, log on to: www.sco.ca.gov (916) 324-5961	Estate Tax
Registry of Charitable Trusts (916) 445-2021 (not a toll-free number) Office of Attorney General – Charitable Trusts **Public Inquiry Unit**: (916) 322-3360 (for copies of publications) http://caag.state.ca.us/charities	Charities Charitable Trusts Public Benefit Corporations

CHAPTER 2A

INTRODUCTION TO THE PERSONAL INCOME TAX, CORPORATION TAX, AND SALES AND USE TAX

The personal income tax, corporation tax, and sales and use tax are the "Big Three" of California taxes for several reasons. First, they are the largest sources of revenue. Together they raised $95.2 billion in fiscal year (FY) 2013-14 (95% of all General Fund revenues) and $88.9 billion in FY 2012-13 (93.2% of all General Fund revenues). (Source: 2014-15 Governor's Budget Summary- SUM-04 and 2013-14 Governor's Budget Summary - SUM-04).

Secondly, they are more complex than most of the other taxes. The personal income tax, for instance, has five different filing statuses, nine different tax brackets in each filing status, and dozens of different tax credits and itemized deductions.

Thirdly, these three taxes have the greatest impact on California taxpayers. Nearly all Californians pay the sales tax, and the Franchise Tax Board (FTB) currently receives about 16 million income tax returns each year, most of which report a tax liability. Nearly all of California businesses pay some form of the corporation tax.

The following chapters, therefore, devote many pages to these three taxes. The unitary method of taxation for multistate and multinational corporations, formally known as Uniform Division of Income for Tax Purposes Act (UDITPA), is among the most complicated of all provisions of California tax law and is also discussed. The remaining chapters are devoted to the other California taxes.

Readers may obtain additional information on these taxes by calling the various administrative agencies – the FTB, the State Board of Equalization (BOE), and the Employment Development Department (EDD).

CHAPTER 2A
INTRODUCTION

CHAPTER 2B

PERSONAL INCOME TAX

HIGHLIGHTS

• Tax Rates	1.00% - 12.30%; brackets are indexed annually for inflation.
• Number of Filers*	Over 15.8 million returns filed in 2012 (most recent year for which this information is available).
• Threshold of Taxation* (Gross income)	\$15,702 for single taxpayers with no dependents. \$31,406 for married taxpayers with no dependents.
• Revenue**	2012-13 \$65.3 billion 2013-14 (Forecast) \$64.0 billion 2014-15 (Forecast) \$69.7 billion 65.8% of total General Fund revenues. (2013-14)
• Administration	Franchise Tax Board (FTB)

*Source: FTB
**From the Governor's 2014-15 Budget Summary, Appendix 14, Schedule 8

1. WHO PAYS THE PERSONAL INCOME TAX

Individuals who are residents of California are liable for the personal income tax on income derived from all sources. Nonresidents of this state must pay income tax on income derived from sources within California. However, nonresidents are generally allowed a credit against their California tax for taxes they pay to their state of residence on the same income.

In addition to individuals, partnerships, limited liability companies, estates, and trusts are taxed under the "Personal Income Tax Law".

PERSONAL INCOME TAX COMPONENTS

Federal Income From All Sources
Minus **Exempt Income (examples)**: Nontaxable Social Security and Railroad Retirement; Insurance Proceeds; Bequests and Gifts; Public Assistance; IRA and Keogh Interest; Interest on Certain State and Municipal Government Obligations; Scholarships and Fellowships
Equals **Total Gross Income**: Salaries and Wages; Taxable Interest; Dividends; Taxable State and Local Income Tax Refunds; Alimony Received; Business Income or Loss; Capital Gain or Loss; Other Gains or Losses; Taxable IRA Distributions; Taxable Pensions and Annuities; Income or Loss from Rental Real Estate, Royalties, Partnerships, S Corporations, Estates, Trusts, REMICS, etc.; Farm Income or Loss; Unemployment Compensation; Taxable Social Security Benefits; Other Income; Gambling Winnings including Lotteries and Raffles
Minus **Adjustments to Income**: IRA Deductions; One-Half of Self-Employment Tax; Self-Employed Health Insurance Deduction: Self-employed SEP, SIMPLE, and Qualified Plans; Penalty on Early Withdrawal of Savings; Alimony Paid; Moving Expense; Student Loan Interest Deductions; MSA Deductions; HSA Deductions; Educator Expenses; Tuition and Fees Deduction; Domestic Production Activities Deduction; Certain Business Expenses of Reservists, Performing Artists, and Fee-basis Government Officials
Equals **Federal Adjusted Gross Income** (AGI)
Minus **Federal/State Differences**: State Income Tax Refund; Unemployment Compensation; Taxable Social Security Benefits; Nontaxable Federal Interest and Dividend Income; Railroad Retirement and Sick-Pay; California Lottery Winnings; Earnings and Per Capita Payments of American Indian Tribal Members Living in Indian Country Affiliated with their Tribe; Differences in Clergy Housing Allowance; IRA Distributions - Basis Recovery of IRAs, Differences in Pensions and Annuities; Differences in Passive Activities; Differences in Depreciation and Amortization; Differences in Small Business Expensing Deduction; Differences in Capital Gain or Loss; Differences in Other Gain or Loss; Differences in Net Operating Losses; Differences in Alimony Paid
Plus **Federal/State Differences**: Interest on State or Municipal Bonds From Other States; Differences in Passive Activities; Differences in Depreciation and Amortization; Differences in Small Business Expensing Deduction; Differences in IRA Deduction; Differences in Student Loan Interest Deduction; HSA Deductions; Income Exempted by U.S. Treaty; Differences in Clergy Housing Allowance; Educator Expenses; Tuition and Fees Deduction; Differences in Capital Gain or Loss; Differences in Other Gain or Loss; Differences in Net Operating Losses; Domestic Production Activities Deduction; Differences in Certain Business Expenses of Reservists, Performing Artists, and Fee-basis Government Officials; Differences in Alimony Received
Equals **California Adjusted Gross Income** (AGI)
Minus **Deductions**: California Standard Deduction or Federal Itemized Deductions; Adjusted for Federal/State Differences; State, Local and Foreign Income Taxes or General Sales Tax; Interest Paid; Contributions; Casualty and Theft Loss; Employee Business Expense; Federal Estate Tax; Generation Skipping Tax; Private Mortgage Insurance; Miscellaneous Deductions
Equals **California Taxable Income**
Multiplied by **Applicable Marginal Tax Rates**
Minus **Tax Credits** (Credits are allowable only after applicable limitations based on the tentative minimum tax): Exemption for Personal, Blind, Senior and Dependent; Senior Head of Household; Dependent Parent; Child Adoption; Prison Inmate Labor; Enterprise Zone Employee; Joint Custody Head of Household; Low-Income Housing; Enterprise Zone Hiring and Sales Tax; Research; Other States Taxes; Employer Child Care Program and Contribution: Prior year Alternative Minimum Tax; Local Area Military Base Recovery Area; Manufacturing Enhancement Area; Targeted Tax Area; Natural Heritage Preservation; Environmental Tax Credit; Nonrefundable Renter's Credit; Disabled Access for Small Business; Enhanced Oil Recovery; Transportation of Donated Agricultural Products; Community Development Qualified Deposit; Carryovers from Repealed Credits; New Jobs; Child and Dependent Care Expenses Credit; Fresh Fruits and Vegetables Credit.
Plus **Other Taxes**: Alternative Minimum Tax; Tax on Early Use of IRA, Keogh or Annuity Contract; Tax on Accumulation Distributions of Trusts; Lump-Sum Distribution; Recapture Taxes; Use Tax; Mental Health Services Tax
Equals **Total Tax Liability**
Minus **Payments and Refundable Credits**: Income Tax Withholding; Estimated Tax; Payment with Extensions; Excess SDI or VPDI; Overpayment Applied from Prior Year; Real Estate or Other Withholdings
Plus **Voluntary Contributions**
Equals **Overpayment or Balance Due**

Source: Franchise Tax Board

2. CALCULATION OF THE PERSONAL INCOME TAX

Taxpayers must compute their tax liability based on income earned during the year, usually the calendar year. Generally, taxpayers must add up all sources of nonexempt income and subtract the adjustments and deductions to which they are entitled to calculate "taxable income". They then apply the appropriate tax rate to their taxable income to arrive at a preliminary tax liability. After calculating their preliminary tax liability, taxpayers may then apply tax credits, which reduce liability (i.e., every $1 in tax credits reduces a taxpayer's tax liability by $1). In most cases, the tax liability remaining after tax credits are applied is the actual tax liability. However, a few taxpayers are liable for additional taxes under special circumstances.

The chart on the preceding page illustrates the steps involved in calculating final tax liability. As the chart shows, the income that is actually subject to tax is much smaller than a taxpayer's total income earned or received.

3. RELATIONSHIP OF STATE AND FEDERAL TAX FORMS

California's tax law largely conforms to federal income tax law. This allows substantial simplicity for state tax forms. Today, a majority of the steps in computing income subject to tax are done on federal Forms 1040, 1040A, or 1040EZ. California Form 540 starts with federal adjusted gross income (AGI), then requires taxpayers to make adjustments to reflect differences in state law, apply state tax credits, and compute state tax.

A second state form, without a comparable federal form, offers taxpayers a different, simplified method of calculating their taxes. Beginning with the 1999 tax year, Form 540 2EZ replaced Form 540 EZ. Form 540 2EZ begins with the taxpayer's total wages. However, the tax tables that accompany Form 540 2EZ already include the standard deduction and personal and dependent exemption credits, thereby simplifying the calculation processes required for other state forms.

In addition to the state forms available on the FTB Web site, California also offers ReadyReturn, a free service the FTB developed to make filing individual income tax returns easier. The FTB uses information from the last return filed by the taxpayer and from the taxpayers' current W-2 forms to pre-fill a California state tax return. Currently, there is no comparable federal program.

4. TAXABLE AND NONTAXABLE INCOME

For purposes of the personal income tax, income is measured or defined in four important stages: (a) Calculation of exempt income; (b) Gross income; (c) AGI; and (d) Taxable income (TI).

The major sources of income that are taken into account in computing tax liability include the following:

- Gross Income. Gross income is the starting point for calculating tax on the federal return. Gross income includes income from all sources, unless otherwise exempt. Income that must be included in gross income for both state and federal purposes includes salaries, wages, commissions, tips, alimony received, dividends, interest earnings, annuities, pensions, net gains from the sale of capital assets, net partnership and proprietorship income, net farm income, and others. Losses from capital assets, partnerships, proprietorships may be limited.

For some items, the amount of income entered on the tax return may be a negative number if the taxpayer has incurred a loss.

- Exempt Income. Certain types of income are exempt from tax. In many cases, taxpayers are not required to report this income on their tax return. Some of these items are exempt in California but are taxable for federal purposes. The most common income items that are taxable on the federal return and exempt on the state return are California lottery winnings, a portion of Social Security and Railroad Retirement benefits, unemployment compensation, and interest from U.S. Savings Bonds and Treasury Bills. Since California uses federal income as the starting figure, these items must be subtracted from federal income before calculating California tax.

- Adjusted Gross Income. After totaling all items included in gross income, certain deductions are allowed to compute AGI. These "adjustments" include payments into certain retirement plans (IRAs, Keogh plans, self-employed plans, etc.), alimony paid, penalties paid on early withdrawal of savings, and the employer portion of Social Security that is paid by the self-employed (i.e., the self-employment tax). The remaining amount is AGI.

- Taxable Income. Either the standard deduction or itemized deductions may further reduce AGI. These are described below. The remaining amount is taxable income. Tax rates are applied to this amount in order to compute tax owed before credits.

5. DEDUCTIONS FROM ADJUSTED GROSS INCOME (AGI)

All taxpayers are allowed to deduct certain amounts from AGI. Most deductions are intended to reduce the amount of income subject to tax to reflect certain living costs incurred by all taxpayers. The rationale behind deductions is that these living costs affect taxpayers' ability to pay.

The value of a deduction to a taxpayer (i.e., the amount by which the deduction reduces the taxpayer's tax liability) generally may be estimated by multiplying the deduction by the taxpayer's highest marginal tax rate (see Section 8 of this chapter for a discussion of marginal rates). For example, the approximate state tax savings to a person in the top tax bracket (12.30%) who deducts a $100 expense is $12.30 ($100 expense times the 12.30% tax rate).

A taxpayer may reduce his or her AGI by the larger of either the standard deduction or the total of his or her allowed itemized deductions.

Standard Deduction. The standard deduction is a fixed dollar amount intended to approximate deductible living expenses. For the 2013 taxable year, the standard deduction amounts under California law are as follows:

Single and Married/Registered Domestic Partner (RDP) Filing Separately	$3,906
Married/RDP Filing Jointly, Qualifying Widow(er), and Head of Household	$7,812

These amounts are indexed annually for inflation.

Standard deduction amounts under federal law are different from those in California law. In 2013, federal amounts are as follows:

Single	$ 6,100
Married/RDP Filing Jointly or Qualifying Widow(er)	$12,200
Head of Household	$ 8,950
Married/RDP Filing Separately	$ 6,100

Federal law also allows taxpayers to increase their standard deductions if they have dependents, are over age 65, and/or blind.

Unlike federal law, California does not allow larger standard deductions for taxpayers that have dependents and/or are over age 65 and/or blind. Instead, state law provides exemption credits (see Section 7).

Itemized Deductions. As an alternative to the standard deduction, both state and federal law allow various specific expenses (called itemized deductions) to be deducted from AGI. The major itemized deductions permitted include the following:

- Home mortgage interest on first and second homes, subject to certain limits;
- Property taxes;
- Charitable contributions up to an annual cap. Amounts above the cap may be carried over and deducted in subsequent years;
- Unreimbursed medical expenses in excess of 7.5% of AGI;
- Unreimbursed casualty and theft losses of over $100. However, only losses in excess of 10% of AGI may be deducted; and
- Certain miscellaneous expenses in excess of 2% of AGI. Examples of deductible miscellaneous expenses include union dues, uniforms, job-related educational expenses, tax return preparation fees, safe deposit box costs, and unreimbursed business expenses.

California's rules on itemized deductions are very similar to federal rules. The major difference is that federal law allows an itemized deduction for state income taxes paid, whereas California law does not.

State limits itemized deductions for high-income filers. For 2013, the California phase-out affects single filers with AGIs in excess of $172,615, joint filers with AGIs in excess of $345,235, and head of household filers with AGIs in excess of $258,927.

Exemptions. In addition to allowing taxpayers a choice of claiming either the standard deduction or itemizing deductions, federal law also allows taxpayers to claim personal and dependent exemptions. The 2013 federal exemption amount equals $3,900. Starting with tax year 2011, taxpayers no longer lose part of their deduction for personal and dependent exemptions, regardless of the amount of the taxpayer's AGI.

6. FILING STATUS

Taxpayers must file using one of five filing statuses: (a) Single; (b) Married Filing Separately; (c) Married Filing Jointly; (d) Head of Household; or (e) Qualifying Widow(er).

Filing status affects tax liability because it determines which tax rate schedules and personal exemption credits a taxpayer may claim on his or her return.

A head of household is generally a person who is not married at the end of the taxable year and who has a child or other relative living with him or her for more than half the year.

A taxpayer qualifies to file as a qualifying widow(er) if he or she is a widow(er) who remains unmarried and maintains a dependent in the home. The taxpayer may file as a qualifying widow(er) for the two tax years following the tax year in which the taxpayer's spouse dies. In the year the spouse dies, the taxpayer must file a joint return. The qualifying widow(er) filing status generally permits the use of tax rates, deductions, and credits similar to those used by joint filers.

In general, California taxpayers must use the same filing status on their state returns as they use on their federal returns. In certain situations where one spouse is in the military or a nonresident, or the taxpayers are RDPs, California permits a filing status different from the filing status claimed on the taxpayer's federal return. A taxpayer might choose different filing statuses at the state and federal level if he or she could lower his or her tax liability by doing so. Effective for tax years beginning in 2007, taxpayers registered with the Secretary of State as RDPs are required to use a filing status of either married/RDP filing jointly or married/RDP filing separately for California purposes, regardless of their federal filing status. [SB 1827 (Migden), Chapter 802, Statutes of 2006; SB 105 (Migden), Chapter 426, Statutes of 2007.]

7. PERSONAL, DEPENDENT, SENIOR, AND BLIND EXEMPTION CREDITS

California taxpayers are entitled to personal and dependent exemption credits in addition to their deductions. These exemption credits are intended to shelter a minimum amount of income of each person in the household from tax. The federal government offers similar tax relief through the personal/dependent exemptions and increased standard deductions for certain qualifying individuals.

The personal exemption credit can be claimed by all taxpayers, except those who can be claimed as a dependent on another person's return. An example would be a college student who earns enough income to file his or her own tax return, but who is also eligible to be claimed as dependent on his or her parents' return.

A dependent exemption credit may be claimed for any relative of the taxpayer (child, stepchild, parent, stepparent, sibling, etc.) whom the taxpayer supports for over half of the calendar year. A non-relative who lives in the taxpayer's home and is supported by the taxpayer can also be claimed as a dependent.

An additional exemption credit can be claimed for any person in a household who is blind or age 65 or older on the last day of the taxable year. A person who is both blind and a senior is eligible for two additional exemption credits in addition to the personal or dependent exemption credit.

The 2013 personal, dependent, senior and blind exemption credits are as follows:

Single, Head of Household and Married/RDP Filing Separately	$ 106
Married/RDP Filing Jointly and Qualifying Widow(er)	$ 212
Each Dependent	$ 326
Additional Credit for Person Over Age 65	$ 106
Additional Credit for Blind Person	$ 106

These credits are indexed for inflation annually.

State exemption credits are phased out for taxpayers with federal AGIs that exceed a threshold amount. The threshold amounts for 2013 are $345,235 [married/RDP filing jointly and qualifying widow(er)], $258,927 (head of household), and $172,615 (single and married/RDP filing separately). Like the exemption credits, the phase-out threshold amounts are indexed for inflation annually.

For state tax purposes, when a taxpayer reaches the phase-out threshold, he or she is required to reduce his or her credits by $6 (if a single taxpayer, head of household, or married/RDP filing separately) or $12 [if married/RDP filing jointly or qualifying widow(er)] for each $2,500 ($1,250 if married filing separate) by which that taxpayer's AGI exceeds the threshold amount. For example, a married/RDP couple with two dependents would have their total exemption credits reduced by $24 (12 + 6 + 6) for each $2,500 by which their AGI exceeded the threshold amount.

8. TAX RATES AND BRACKETS

As a result of the recent approval of Proposition 30, California income tax rates have increased for taxpayers with taxable income of more than $250,000, effective retroactive by January 1, 2012. California's maximum marginal rate will now be 12.3% for taxable years beginning on January 1, 2012 and ending on December 31, 2018.

Proposition 63, approved by the voters in November 2004, adds a 1% surtax on that portion of a taxpayer's taxable income in excess of $1 million, effective for tax years beginning on January 1, 2005. Revenues of $1.60 billion are estimated for the 2012-13 fiscal year. Annual revenues of $1.38 billion for 2013-14, and $1.56 billion for 2014-15 are projected. Approximately 40,070 tax returns were liable for the surcharge for the 2011 taxable year.

Revenue generated by the Proposition 63 tax surcharge is used to expand existing county mental health programs and create new programs.

California law provides for nine (9) progressive marginal tax rates applied to taxable income: 1.00%, 2.00%, 4.00%, 6.00%, 8.00%, 9.30%, 10.30%, 11.30%, and 12.30%. The term "marginal tax rate" refers to the rate applied to the last (or highest) dollar of taxable income. Additionally, as noted above, for tax years beginning on or after January 1, 2005, a 1% surtax is imposed on taxable income in excess of $1 million.

Under a system of progressive marginal tax rates (or "brackets"), each additional increment of income a person earns is subject to a higher tax rate. For example, the first increment of income is taxed at a rate of 1.00%, the second (next greater) increment is taxed at a rate of 2.00%, the third increment is taxed at a rate of 4.00%, and so on. The principle behind progressive marginal tax rates is that people with more income have a greater ability to pay taxes than those with lower incomes.

The California tax rates and income brackets that apply for the 2013 year are shown in Table 2 on the next page. Note that each filing status has the same rates of tax but the amounts of income included in each respective bracket are different. Table 2 shows that in 2013, the maximum tax rate of 12.30% applied to single taxpayers with taxable incomes of $500,000 or more and to married taxpayers with taxable incomes of $1,000,000 or more. The income brackets are indexed annually for inflation (see Section 10 of this chapter).

TABLE 2

CALIFORNIA TAX RATES FOR 2013

IF TAXABLE INCOME IS:

Over:	But Not Over:	The Tax Amount is:
Single Person or Married/RDP Filing Separate – Schedule X		
$ 0	$ 7,582	1.00% of the amount over $0
$ 7,582	$ 17,976	$75.82 plus 2.00% of the amount over $7,582
$ 17,976	$ 28,371	$283.70 plus 4.00% of the amount over $17,976
$ 28,371	$ 39,384	$699.50 plus 6.00% of the amount over $28,371
$ 39,384	$ 49,774	$1,360.28 plus 8.00% of the amount over $39,384
$ 49,774	$254,250	$2,191.48 plus 9.30% of the amount over $49,774
$254,250	$305,100	$21,207.75 plus 10.30% over $254,250
$305,100	$508,500	$26,445.30 plus 11.30% over $305,100
$508,500	No Limit	$49,429.50 plus 12.30% over $508,500
Married/RDP Filing Joint or Qualifying Widow(er) with Dependent Child – Schedule Y		
$ 0	$ 15,164	1.00% of the amount over $0
$ 15,164	$ 35,952	$151.64 plus 2.00% of the amount over $15,164
$ 35,952	$ 56,742	$567.40 plus 4.00% of the amount over $35,952
$ 56,742	$ 78,768	$1,399.00 plus 6.00% of the amount over $56,742
$ 78,768	$ 99,548	$2,720.56 plus 8.00% of the amount over $78,768
$ 99,548	$ 508,500	$4,382.96 plus 9.30% of the amount over $99,548
$ 508,500	$ 610,200	$42,415.50 plus 10.30% over $508,500
$ 610,200	$1,017,000	$52,890.60 plus 11.30% over $610,200
$1,017,000	No Limit	$98,859.30 plus 12.30% over $1,017,000
Head of Household – Schedule Z		
$ 0	$ 15,174	1.00% of the amount over $0
$ 15,174	$ 35,952	$151.74 plus 2.00% of the amount over $15,174
$ 35,952	$ 46,346	$567.30 plus 4.00% of the amount over $35,952
$ 46,346	$ 57,359	$983.06 plus 6.00% of the amount over $46,346
$ 57,359	$ 67,751	$1,643.84 plus 8.00% of the amount over $57,539
$ 67,751	$345,780	$2,475.20 plus 9.30% of the amount over $67,751
$345,780	$414,936	$28,331.90 plus 10.30% over $345,780
$414,936	$691,560	$35,454.97 plus 11.30% over $414,936
$691,560	No Limit	$66,713.48 plus 12.30% over $691,560

TABLE 3

FEDERAL TAX RATES FOR 2013

IF TAXABLE INCOME IS:

Over:	But Not Over:	The Tax Amount is:
Single Person - Schedule X:		
$ 0	$ 8,925	10% of the amount over $0
$ 8,925	$ 36,250	$892.50 plus 15% of the amount over $8,925
$ 36,250	$ 87,850	$4,991.25 plus 25% of the amount over $36,250
$ 87,850	$183,250	$17,891.25 plus 28% of the amount over $87,850
$183,250	$398,350	$44,603.25 plus 33% of the amount over $183,250
$398,350	$400,000	$115,586.25 plus 35% of the amount over $398,350
$400,000	No Limit	$116,163.75 plus 39.6% of the amount over $400,000
Married/RDP Filing Joint or Qualifying Widow(er) - Schedule Y-1:		
$ 0	$ 17,850	10% of the amount over $0
$ 17,850	$ 72,500	$1,785 plus 15% of the amount over $17,850
$ 72,500	$146,400	$9,982.50 plus 25% of the amount over $72,500
$146,400	$223,050	$28,457.50 plus 28% of the amount over $146,400
$223,050	$398,350	$49,919.50 plus 33% of the amount over $223,050
$398,350	$450,000	$107,768.50 plus 35% of the amount over $398,350
$450,000	No Limit	$125,846 plus 39.6% of the amount over $450,000
Married/RDP Filing Separately - Schedule Y-2:		
$ 0	$ 8,925	10% of the amount over $0
$ 8,925	$ 36,250	$892.50 plus 15% of the amount over $8,925
$ 36,250	$ 73,200	$4,991.25 plus 25% of the amount over $36,250
$ 73,200	$111,525	$14,228.75 plus 28% of the amount over $73,200
$111,525	$199,175	$24,959.75 plus 33% of the amount over $111,525
$199,175	$225,000	$53,884.25 plus 35% of the amount over $199,175
$225,000	No Limit	$62,923 plus 39.6% of the amount over $225,000

<u>Head of Household - Schedule Z</u>:

$ 0	$ 12,750	10% of the amount over $0
$ 12,750	$ 48,600	$1,275 plus 15% of the amount over $12,750
$ 48,600	$125,450	$6,652.50 plus 25% of the amount over $48,600
$125,450	$203,150	$25,865 plus 28% of the amount over $125,450
$203,150	$398,350	$47,621 plus 33% of the amount over $203,150
$398,350	$425,000	$112,037 plus 35% of the amount over $398,350
$425,000	No Limit	$121,364.50 plus 39.6% of the amount over $425,000

9. INDEXING

Many components of the Personal Income Tax Law used to calculate tax liability are modified annually to adjust for inflation using a method called indexing. For example, income brackets, exemption credits, the standard deduction, the joint custody head of household credit, and many of the phase-out limits in the Personal Income Tax Law are indexed annually. Indexing is intended to prevent taxpayers from being pushed into higher marginal tax brackets by increases in income that just keep pace with inflation, while the taxpayers' real buying power is not increasing.

The indexing adjustment equals the percentage difference between the California Consumer Price Index (CCPI) in June of the current year and June of the prior year. Each dollar value to be indexed is multiplied annually by this percentage change.

Indexing is illustrated below using one of the most important components of the personal income tax – brackets. As noted above, annual indexing of income within the tax brackets is intended to keep a taxpayer in the same bracket, as long as his or her income increases no faster than the CCPI. For example, the effect of indexing on two hypothetical taxpayers would be as follows:

- A taxpayer who gets a cost-of-living wage increase exactly equal to inflation will have more income in dollars but will have the same buying power as is in the previous year. Without indexing, the taxpayer's increased income might bump him or her into a higher marginal tax bracket, causing the taxpayer to owe additional income tax reflecting a higher tax rate as well as increased income. Indexing keeps the taxpayer's tax rate at the same level as the prior year, since the taxpayer's buying power remains the same.

- A taxpayer on a fixed income loses buying power in inflationary times. Without indexing, the taxpayer's tax liability would remain the same, even though the taxpayer's income was worth less in each succeeding year.

Indexing of the tax rate brackets lowers the taxpayer's tax liability, consistent with the taxpayer's decline in buying power.

Federal law began indexing tax rate brackets in 1985 and the standard deduction in 1989. The federal indexing measure differs from California through use of the U.S. Consumer Price Index and a different 12-month period (August to August).

10. TAX CREDITS

Tax credits reduce tax liability on a dollar-for-dollar basis (i.e., $1 in tax credits reduces a taxpayer's tax liability by $1). After the taxpayer computes tax due for his or her taxable income, he or she subtracts the credits to which he or she is entitled, thereby reducing the amount of tax due. Thus, credits have a greater impact than deductions, whose value in

reducing tax liability (as discussed in Section 5 of this chapter) equals the amount of the deduction times the tax rate. Most state tax credits are not refundable if they exceed total tax due. However, in some cases credits that exceed tax liability may be carried forward and claimed against a taxpayer's future years' taxes.

Credits are usually provided to give tax relief to people who incur certain non-discretionary costs, have limited ability to pay taxes, or to provide incentives to people to engage in certain activities that are socially or economically desirable. Tax reform legislation enacted in 1987 placed sunset dates (i.e., automatic repeal) on many credits in the Personal Income Tax Law in order to give the Legislature an opportunity to evaluate their impact.

The amount of the tax credits allowable in any taxable year may be limited by the taxpayer's alternative minimum tax liability or by tentative minimum tax (see Section 14 of this chapter for further information).

Some of the tax credits allowed in state law are similar to credits offered in federal law. However, in most cases the federal credits are larger.

The most significant credits allowed in state law are described below. The credits are available to both full-time and part-time California residents, as well as to nonresidents with California-source income. California residents are entitled to the full value of each credit, as long as they meet all of the eligibility criteria for the credits. Nonresidents and part-year residents are required to prorate the amount of each credit claimed using rules specified in statute.

Renter's Credit. The Legislature enacted a "renter's credit" in 1972. In the first 20 years following its inception, both the value of the credit and the income eligibility rules applied to taxpayers that claimed the credit varied, but the credit was always available. However, the renter's tax credit was suspended when California experienced severe economic pressures in the early 1990s. As part of budget agreements, the credit was not available during the five-year period corresponding to the 1993 through 1997 taxable years. The Legislature reinstated the renter's credit effective January 1, 1998.

Historically, the renter's tax credit was also refundable. However, as reinstated, the renter's credit is nonrefundable and is subject to income phase-outs. For 2013, married/RDP taxpayers filing jointly, heads of household, and qualifying widow(er) with AGIs of $73,910 or less may claim a credit of $120. Single taxpayers and married/RDP taxpayers filing separately with AGIs of $36,955 or less may claim a credit of $60. See Chapter 6E (Renter's Credit) for more information.

There is no similar credit in federal law.

Senior Head of Household Credit. Taxpayers who are 65 years of age or older on December 31st of the current tax year, qualified as head of household during either the previous two tax years by providing a household for a qualifying individual who died during one of the previous two tax years, and whose AGI for 2013 is $67,520 or less, may claim a credit equal to 2% of taxable income. For 2013, the maximum allowable credit is $1,272. The AGI cap and maximum allowable credit are indexed annually for inflation.

There is no similar credit in federal law.

Joint Custody Head of Household Credit. Taxpayers who qualify as joint custody heads of household may claim a state tax credit that offsets a portion of their tax liability. To qualify, the taxpayer must: (a) be unmarried at the end of the year; (b) have custody of a dependent under a custody agreement for between 146 and 219 days of the year; and (c) furnish over half of all household expenses. The credit is 30% of the net tax, not to exceed $416 for the 2013 tax year. The maximum available credit is indexed for inflation annually. The purpose of this credit is to allow divorced couples who share custody of a child to share the benefits of the head of household filing status. A similar credit is available to separated married persons who support a dependent parent.

There is no similar credit in federal law.

Credit for Taxes Paid to Other States. In order to avoid double taxation, California residents are generally allowed a credit for income taxes paid to another state on income that is also taxed by California. The credit may not exceed the tax California would have imposed on the income taxed by such other state. If the other state taxes this income at a lower rate than California, this credit has the effect of allowing California to tax only a portion of the income taxed by the other state.

Excess Employee's State Disability Insurance (SDI) Credit. Employees who work for more than one employer and who earned over $100,880 during the 2013 tax year may have paid more than the maximum State Disability Insurance through over-withholding.

The excess may be recovered by claiming a credit against the California personal income tax on a Form 540 or 540A tax return.

Child Adoption Cost Credit. This credit is equal to 50% of the costs of adopting a minor child who is a citizen or legal resident of the United States and is in the custody of a California public agency or a political subdivision of California. The credit can be claimed in the taxable year in which the decree or order of adoption is entered, even though qualifying costs paid or incurred in prior years may qualify for the credit. Costs eligible for the credit include: (a) fees for required services of either the Department of Social Services or a licensed adoption agency; (b) travel and related expenses for the adoptive family that are directly related to the adoption process; and (c) medical fees and expenses that are not reimbursed by insurance and are directly related to the adoption process. The maximum allowable credit cannot exceed $2,500 per minor child. This credit may be carried over and is allowed for taxable years beginning on or after January 1, 1994.

Federal tax law also offers a child adoption cost credit. Taxpayers may claim a credit of up to $12,970 for the qualified adoption expenses of each eligible child. Phase-out of the federal credit begins for taxpayers with modified AGIs of more than $194,580; the federal credit is completely phased out for taxpayers with modified AGIs of $234,580 or more for the 2013 tax year. The limitation on eligible expenses and phase-out incomes are increased for inflation annually. Qualified adoption expenses include reasonable and necessary adoption fees, court costs, attorney fees, and other expenses directly related to the legal adoption of an eligible child. For years beginning after 2011, the federal credit is no longer refundable.

Child and Dependent Care Credit. Beginning with the 2000 taxable year, taxpayers that maintain a household within the state for a qualifying individual may claim the child and dependent care credit for employment-related expenses. The state credit supplements a similar federal household and dependent care credit.

As defined by the federal law, a qualifying individual is a dependent of the taxpayer that is under the age of 13 or a dependent or spouse who is physically or mentally unable to care for himself or herself. Employment-related expenses are defined as those incurred to enable the taxpayer to obtain or retain gainful employment.

The federal credit, which can be applied to a maximum of $3,000 in expenses for one dependent and $6,000 in expenses for two or more dependents, is equal to between 20% and 35%, depending on a taxpayer's AGI. Taxpayers with AGIs of $15,000 or less are eligible for the 35% credit. The amount of the credit decreases by one percentage point for each $2,000 by which a taxpayer's AGI exceeds $15,000. Thus, a credit of 20% may be claimed by taxpayers with AGIs over $43,000.

The state credit amount is a percentage of the federal credit, as follows:

California AGI	Credit Percentage (% of Federal Credit)
$40,000 or less	50%
$40,001 to $70,000	43%
$70,001 to $100,000	34%
Over $100,000	0%

California taxpayers may claim the state credit regardless of whether they have federal tax liability. For years beginning after 2010, the federal credit is no longer refundable.

Donated Fresh Fruits or Fresh Vegetables Credit. Qualified taxpayers may claim a credit equal to 10% of the costs of fresh fruits or fresh vegetables donated to a California food bank.

A "qualified taxpayer" is defined as the person responsible for planting the crop, managing the crop, and harvesting the crop from the land. The cost of donated fresh fruits or fresh vegetables is the cost of those products that would otherwise be included in inventory costs. Generally, inventory costs would include both the direct costs and the allocated indirect costs required to produce the fresh fruits or fresh vegetables. Because inventory costs are costs of doing business, the credit is available only to a business that is also a qualified taxpayer.

The recipient of a donation of fresh fruits or fresh vegetables must provide to the donor certification of the type and quantity of the products donated, the name of the donor or donors, the name and address of the done nonprofit organization, and, as provided by the donor, the estimated value of the donated products and the location where the donated product was grown. A donor that is a qualified taxpayer must provide a copy of the certificate to the FTB upon request.

The fresh fruits and fresh vegetables credit applies to taxable years beginning on or after January 1, 2012, and before January 1, 2017. This credit may be carried forward for up to six years and may not reduce the tax below tentative minimum tax for AMT purposes.

Credits for Businesses. A number of other credits are available for business taxpayers that file under the personal income tax law, such as sole proprietorships and partnerships. The total business credit allowed for taxpayers with net business income (PIT) greater than $500,000 is limited to 50% of the total credit available for taxable years beginning on or after January 1, 2008, and before January 1, 2010. Any credit amount in excess of the limitation is eligible for carryforward. [AB 1452 (Committee on Budget), Chapter 763, Statutes of 2008.] Refer to the Corporation Tax chapter (Chapter 2C) for a description of tax credits applicable to businesses.

11. CAPITAL GAINS AND LOSSES

Capital gains are profits from the sale of property and other capital assets. They are classified as a different type of income from "ordinary income," which includes wages, salaries, and interest.

Capital assets are defined as all property except the following: inventories; property held for sale in the ordinary course of business; depreciable business property; and real property used in business. Capital assets include real property (land and buildings), personal property, and intangible assets (such as stock).

Capital gains are measured as the difference between the amount realized when the asset is sold and the asset's basis. Although an asset's basis is normally that asset's original purchase price, basis can be adjusted to reflect improvements and costs of sale. Any amounts invested in improvements are added to the purchase price to increase basis; costs of sale are deducted from the sales price to reduce basis. Capital gains are generally recognized in the year an asset is sold or otherwise disposed.

Through 1986, capital gains were accorded special tax treatment in California. During that time, gains on assets held longer than one year were partially excluded from tax. However, beginning in 1987, California began including all capital gains within the measure of a taxpayer's income. California's tax treatment of capital gains is different from federal treatment, because California applies the same tax rates to capital gains as applies to ordinary income; the federal government applies lower rates to qualifying capital gains.

Under federal (but not state) law, most types of investments held more than one year are subject to capital gains tax at a top rate of 20% (10% for investors in the 15% tax bracket) if the sale takes place before May 6, 2003.

For sales on or after May 6, 2003, and before January 1, 2013, the maximum capital gain rate is 15% (5% for individuals taxed in the 10% or 15% tax bracket, or at a zero percent rate for tax years beginning after 2007).

These lower rates apply to most (but not all) types of investments. Among those ineligible are collectibles with a maximum rate of 28%. Nor do the lower rates apply to gains from the sale of investment real estate to the extent of depreciation deductions previously claimed with a maximum rate of 25%.

Special enacted state and federal laws provided an exemption for 50% of the capital gains realized from the sale of qualified small business stock (QSBS) issued after August 10, 1993, and before February 18, 2009, and be held for a least five years prior to sale. For QSBS acquired after September 27, 2010, and before 2012, and held for at least five years, federal law provides an exemption for all of the gain on the disposition of the

QSBS stock. For QSBS acquired after February 17, 2009, and before September 28, 2010, and held for at least five years, federal law provides an exemption of 75% of any gain realized on the disposition of QSBS stock. For state tax purposes, the company in which the investment is made must have had at least 80 percent of its payroll in California at the time of the investment acquisition and have assets of not more than $50 million. Certain industry and other limitations apply, including industry growth in payroll, etc.

In *Cutler v. Franchise Tax Board* (2012) 208 Cal.App. 4th 1247, 146 Cal.Rptr. 3d 244, the California Court of Appeals held that the California QSBS provisions of R&TC Sections 18038.5 and 18152.5 are unconstitutional.

AB 1412 (Chapter 546, Statutes of 2013) provides a limited, modified California QSBS exclusion by allowing taxpayers to exclude 50% of the gain from the sale or exchange of their California QSBS for taxable years beginning on or after January 1, 2008, and before January 1, 2013. In addition, taxpayers are allowed to exclude 50% of the gain included in installment payments received, or that will be received, in taxable years beginning on or after January 1, 2008, for sales of California QSBS made in taxable years beginning before January 1, 2013.

For the purposes of this limited, modified exclusion, the definition of "qualified small business" means a domestic C corporation that meets the following:

- The aggregate gross assets of the corporation (or its predecessor) at all times on or after July 1, 1993, and before the issuance of the stock, did not exceed $50 million;

- The aggregate gross assets of the corporation immediately after the issuance did not exceed %50 million; and,

- At least 80 percent of the corporation's payroll is attributable to employment located within California (at time of stock issuance).

As under federal law, capital losses are fully deductible against capital gains realized in the same year. In addition, up to $3,000 of capital losses in excess of capital gains are deductible against ordinary income in any taxable year. If excess capital losses are greater than $3,000, the unused portion may be carried forward indefinitely to offset capital gains in future years and to deduct against ordinary income subject to the $3,000 annual limit. Federal law allows a three-year carryback of capital losses, but California does not.

State law also conforms to federal capital gains treatment on sale or exchange of a principal residence. Specifically, state and federal laws provide that a single taxpayer may exclude up to $250,000 and married taxpayers filing jointly may exclude up to $500,000 of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling a principal residence meets certain eligibility requirements, but generally no more frequently than once every two years. To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. Federal and state laws repealed the once-in-a-lifetime exclusion of $125,000 and the rollover of gain from the sale of a principal residence provisions that previously existed.

12. DEPRECIATION AND AMORTIZATION

Depreciation and amortization deductions allow taxpayers to recover capital investments in certain assets over the useful lives of those assets by deducting reasonable allowances for the exhaustion, wear, and tear of property.

Depreciation and amortization are allowed for property used in a trade or business or for the production of income (investment). Depreciable property includes most kinds of tangible property and improvements to real property, farm buildings, machinery, and other physical assets. Intangible assets that may be amortized include copyrights, licenses, franchises, goodwill, and covenants not to compete. Depreciation and amortization are not allowed for property used for personal purposes, inventory and stock in trade, land, and depletable natural resources.

Under the personal income tax law, California generally conforms to the federal depreciation system for assets placed in service on and after January 1, 1987. This is called the Modified Accelerated Cost Recovery System (MACRS). Under MACRS, all depreciable assets are placed in classes. These class assignments determine the assets' useful lives (i.e., the periods over which the assets may be depreciated) and the method of depreciation that must be used. The amount to be depreciated is the property's basis or its acquisition price. In general, MACRS allows shorter useful lives and more accelerated depreciation methods than are allowed under other permissible depreciation systems, thereby allowing larger depreciation deductions.

Under federal (but not state) law, a taxpayer is allowed to elect to take a bonus first-year depreciation deduction equal to 30% of the adjusted basis of qualified property (including New York Liberty Zone property) placed in service by the taxpayer after September 10, 2001. That percentage increases to 50% for property placed in service after May 5, 2003, and before January 1, 2011. The first-year bonus depreciation allowance is increased to 100% for qualifying property placed in service after September 8, 2010, and before January 1, 2012. The 50% bonus allowance is extended to cover qualifying property placed in service after December 31, 2011, and before January 1, 2013. The additional first year depreciation deduction generally is determined without any proration based on the length of the taxable year in which the qualified property or New York Liberty Zone property is placed in service. The adjusted basis of this property generally is its cost or other basis multiplied by the percentage of business/investment use, reduced by the amount of any Section 179 expense deduction and adjusted to the extent provided by other provisions of the Internal Revenue Code. The remaining adjusted basis of this property is depreciated using the applicable depreciation provisions under the Code for the property. This depreciation deduction for the remaining adjusted basis of the qualified property or New York Liberty Zone property for which the additional first year depreciation is deductible is allowed for both regular tax and alternative minimum tax purposes.

In addition, in lieu of depreciation, existing federal and state laws (Internal Revenue Code Section 179) allow a deduction to taxpayers with a sufficiently small amount of capital expenditures for depreciable property. These taxpayers may elect to expense (i.e., to deduct immediately rather than depreciate over time) the cost of qualified property placed in service for the taxable year and purchased for use in the active conduct of a trade or business. Federal and state limits differ.

In 2010, the Small Business Jobs Act (SBJA) of 2010 was enacted. This act increases the IRC Section 179 limitations on the expensing of depreciable business assets and expands the definition of qualified property to include certain real property for the 2010 and 2011 tax years. Under the SBJA, qualifying businesses can now expense up to $500,000 of Section 179 property for tax years beginning in 2010 and 2011. Without SBJA, the expensing limit for Section 179 property would have been $250,000 for 2010 and $25,000 for 2011. The maximum Section 179 expense is $125,000 for taxable years beginning in 2012 and $25,000 for taxable years beginning after 2012.

For taxable years beginning in 2010 and 2011, the $500,000 amount provided under the new law is reduced, but not below zero, if the cost of all Section 179 property placed in service by the taxpayer during the tax year exceeds $2,000,000, the investment ceiling. For taxable years beginning after December 31, 2011, and before January 1, 2013, the investment ceiling is $560,000 and $200,000 for tax years beginning after December 31, 2012. The definition of qualified Section 179 property will include qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property for tax years beginning in 2010 and 2011. SBJA also removes cellular telephones and similar telecommunications equipment from the definition of listed property for tax years beginning in 2010.

The limit is $250,000 in 2009 under federal law but remains $25,000 for California. However, starting in 2005, California "C" Corporations are allowed to elect, in lieu of a maximum of $2,000 additional first-year depreciation, a Section 179 deduction of up to a maximum of $25,000. The allowed deduction is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $800,000 under federal law and $200,000 for California.

California permits accelerated write-off for acquisitions of personal property for exclusive use within identified incentive zones. Taxpayers doing business in certain areas such as Enterprise Zones (EZs), Local Agency Military Base Recovery Areas (LAMBRAs), and Targeted Tax Areas (TTAs) may elect to treat 40% of the cost of qualified property purchased for exclusive use within the area as a deduction in the year the property is placed in service. The maximum cost taken into account in any taxable year depends upon the length of time the area has been designated as a qualifying zone or area, but may not exceed $100,000.

The MACRS system is not permitted under the California Corporation Tax Law. However, California law permits S Corporations to compute depreciation under the rules contained in the Personal Income Tax Law. For that reason, S Corporations can use both MACRS and the Section 179 deductions referenced above. Refer to the Corporation Tax chapter of this Reference Book (Chapter 2C) for a description of depreciation deductions allowed for other corporate taxpayers.

13. CARRYOVER OF NET OPERATING LOSSES

Net operating losses (NOLs) occur in the course of a trade or business when deductions exceed income. Under federal law, a net operating loss can be carried back for two years (five years for losses arising in 2001 and 2002, and 2008 and 2009) and carried forward for 20 years. California suspended taxpayers' abilities to claim NOL deductions during the 2008 and 2009 tax years. However, taxpayers were given two additional years in which to claim NOLs accrued prior to January 1, 2009 and one additional year in which to claim NOLs accrued during the 2009 taxable year. Beginning with the 2008 tax year the NOL carryover period is extended to 20 years for NOLs attributable to taxable years beginning on or after January 1, 2008. California allows a two-year carryback period for NOLs attributable to taxable years beginning on or after January 1, 2013. The carryback percentage is 50% for an NOL incurred in tax year 2013, 75% for an NOL incurred in tax year 2014, and 100% for NOLs incurred in tax years 2015 and later. Prior to these changes, California did not normally allow NOL deductions to be carried back. For taxable years beginning before January 1, 2000, California allowed 50% of NOLs to be carried forward for five years. For taxable years beginning in 2010 and 2011, California suspended the net operating loss (NOL) carryover deduction. Taxpayers may continue to compute and carry over NOLs during the suspension period. However, taxpayers with modified adjusted gross income of less than $300,000 or with disaster loss carryovers are not affected by the NOL suspension rules. Beginning with the 2000 tax year, the carryforward periods and carryforward amounts were increased as follows:

Tax Year	Allowed Carryforward	Length of Carryforward
1999 and earlier	50%	5 years
2000, 2001	55%	10 years
2002, 2003	60%	10 years
2004 and after	100%	10 years

In 2002, as part of the budget package, California suspended taxpayers' abilities to claim NOL deductions during the 2002 and 2003 tax years. However, taxpayers were given two additional years in which to claim NOLs accrued prior to January 1, 2002, and one additional year in which to claim NOLs accrued during the 2002 taxable year.

Prior to the changes made in 2002, special NOL carryforward rules were available to specific groups of taxpayers, including new businesses, small businesses, businesses located in EZs, LAMBRAs, and TTAs, and taxpayers involved in bankruptcies and certain bankruptcy reorganizations. Starting in 2004, virtually all businesses are treated the same way under California's NOL laws. Specific details regarding these provisions are described in Section 10 of Chapter 2C.

14. ALTERNATIVE MINIMUM TAX

Non-corporate taxpayers who take advantage of certain tax preferences must calculate and pay an alternative minimum tax (AMT) at a 7% rate if their tentative minimum tax (TMT) exceeds their regular tax due. This rate was 7.25% for tax years 2009 and 2010. The purpose of the AMT is to ensure that taxpayers who take advantage of special tax reduction provisions such as deductions and credits pay at least some minimum amount of tax on their preferentially treated income. California's AMT rules are patterned after federal law, which imposes the AMT at a graduated rate of 26% on the first $175,000 of taxable income above the exemption amount and 28% of the amount exceeding $175,000 above the exemption amount. California's AMT replaced the add-on preference tax, which was a part of California's personal income tax law until 1987.

California taxpayers that believe they may be subject to AMT must perform the following steps to determine whether they owe any tax in addition to their regular tax liability:

- Calculate regular tax liability;
- Calculate alternative minimum taxable income (AMTI) in excess of the exemption amount. Although the AMTI calculation is extremely complex, it generally requires taxpayers to forego their deductions and credits and instead allows them to subtract only a fixed-dollar AMT exemption amount;
- Multiply AMTI by the AMT rate of 7% (7.25% for tax years 2009 and 2010) to calculate TMT; and
- Compare TMT to regular tax liability. If TMT exceeds regular tax, the difference equals the taxpayer's AMT and must be added to the regular tax and paid by the taxpayer.

For 2013, the exemption amounts are $84,640 for married persons filing jointly or qualifying widow(er) filers; $63,481 for single and head of household filers; and $42,319 for married persons filing separately. These exemption amounts phase out to zero if alternative minimum taxable income exceeds $317,401 for married taxpayers filing jointly or qualifying widow(er) filers; $238,051 for single and head of household filers, and $158,700 for married taxpayers filing separately. The exemption and phase-out amounts are indexed annually for inflation.

AMT has an important interaction with tax credits. Most credits can reduce regular tax down to, but not below TMT. However, certain specific credits are not subject to this limitation. These specific credits are:

- Adoption cost credit;
- Commercial solar energy credit carryover;
- Enterprise Zone hiring credit;
- Enterprise Zone sales or use tax credit;
- LARZ hiring credit carryover;
- LARZ sales and use tax credit carryover;
- Los Angeles Revitalization Zone (LARZ) construction hiring credit carryover;
- Motion Picture and Television Production Credit;
- Low-income housing credit;
- Manufacturer's investment credit carryover;
- Natural Heritage Preservation credit;
- Orphan drug credit carryover;
- Personal, dependent, senior, senior head of household, dependent parent, joint custody head of household, and blind exemption credits.
- Renter's credit;
- Research and development credit;
- Solar energy credit carryover;
- Targeted Tax Area hiring credit; and,
- Targeted Tax Area sales or use tax credit.

For a further description of the AMT, refer to Section 14 of Chapter 2C, on the Corporation Tax.

15. TREATMENT OF PENSION AND OTHER RETIREMENT SAVINGS

The tax treatment of pension and other retirement savings plans has two primary elements -- treatment of contributions and treatment of withdrawals. With almost no exceptions, California taxes pension and retirement savings (both contributions and withdrawals) in an identical manner as does the federal government.

Taxation of Contributions. California conforms to federal law with respect to contribution limitations of the various pension and retirement savings plans. Table 4 provides a quick view of the limitations on contributions for numerous programs.

TABLE 4

TYPE OF PLAN	FEDERAL CONTRIBUTION CAPS	ADDITIONAL CATCH-UP CONTRIBUTIONS FOR PERSONS OVER AGE 50
Individual Retirement Accounts (IRAs)	$3,000 in 2002-2004; $4,000 in 2005-2007; $5,000 in 2008-2012; indexed for inflation in $500 increments beginning in 2009.	$500 in 2002-2005; $1,000 in 2006 and thereafter
Defined contribution plans [415(c)s]	100% of compensation or $40,000 in 2003; $41,000 in 2004; $42,000 in 2005; $44,000 in 2006; $45,000 in 2007; $46,000 in 2008; $49,000 in 2009-2011; $50,000 in 2012; and $51,000 in 2013.	
Defined benefit plans [415(b)s]	100% of compensation up to $160,000 for 2003, $165,000 for 2004; $170,000 for 2005; $175,000 for 2006; $180,000 for 2007; $185,000 in 2008; $195,000 in 2009-2011; $200,000 for 2012; and $205,000 for 2013.	
Elective deferral plans [401(k) plans, 403(b) annuities, SEPs 408(k)s]	$11,000 in 2002; $12,000 in 2003; $13,000 in 2004; $14,000 in 2005; $15,000 in 2006; $15,500 in 2007 and 2008; $16,500 in 2009 – 2011; $17,000 in 2012 ; $17,500 in 2013; indexed for inflation in $500 increments beginning in 2007	$1,000 in 2002; $2,000 in 2003; $3,000 in 2004; $4,000 in 2005; $5,000 in 2006 – 2008; $5,500 in 2009 and later
SIMPLE plans [408(p)]	$7,000 in 2002; $8,000 in 2003; $9,000 in 2004; $10,000 in 2005 and 2006; $10,500 in 2007; $10,500 in 2008; $11,500 in 2009 - 2012; indexed for inflation in $500 increments beginning in 2006	$500 in 2002; $1,000 in 2003; $1,500 in 2004; $2,000 in 2005; $2,500 in 2006 - 2012; $3,000 in 2013; catch-up contributions are indexed for inflation in $500 increments beginning in 2007
457 elective deferral plans	$11,000 in 2002; $12,000 in 2003; $13,000 in 2004; $14,000 in 2005; $15,000 in 2006; $15,500 in 2007 and 2008; $16,500 in 2009 – 2011; $17,000 in 2012; $17,500 in 2013; indexed for inflation in $500 increments beginning in 2007	$1,000 in 2002; $2,000 in 2003; $3,000 in 2004; $4,000 in 2005; $5,000 in 2006 – 2008; $5,500 in 2009 - 2013. Plus, the limit is twice the standard limit in a participant's last 3 years before retirement.

Source: http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Contributions

Federal law provides taxpayers with flexibility to roll one type of plan into another type of plan by allowing rollovers among governmental Section 457 plans and Section 403(b) plans, rollovers of IRAs to workplace retirement plans, and rollovers of after-tax retirement plan contributions (e.g., Roth IRAs). Those who have Section 457 plans may use their plan funds to repay contributions and earnings previously refunded to them or to purchase permissive service credits.

Taxation of Withdrawals. As mentioned above, California residents are taxed on all income, including income from sources outside California. An individual who retires in

California will pay tax on the pension income that individual receives after becoming a resident, even if that pension was earned while working in another state.

Federal laws prohibit states from taxing nonresidents on pension income received after December 31, 1995. Because California enacted legislation that conforms to the federal preemption, California does not impose a tax on specified pension income received by a nonresident after December 31, 1995, as follows:

- A qualified pension plan described in Internal Revenue Code (IRC) Section 401;
- A qualified annuity plan described in IRC Section 403(a);
- A tax-sheltered annuity described in IRC Section 403(b);
- A governmental plan described in IRC Section 414(d);
- A deferred compensation plan maintained by a state or local government or an exempt organization described in IRC Section 457;
- An individual retirement plan described in IRC Section 7701(a)(37);
- A simplified employee pension (SEP) described in IRC Section 408(k);
- A trust described in IRC Section 501(c)(18);
- Plans, programs, or arrangements described in IRC Section 3121(v)(2)(C), under certain circumstances; and
- Retired or retainer pay of a member or former member of a uniformed service computed under United States Code, Title 10, Chapter 71.

16. SPECIAL FEATURES OF THE PERSONAL INCOME TAX

Unearned Income of Dependent Children ("Kiddie Tax"). Children under age 18 or children under the age of 24 who are full-time students who have net unearned income (i.e., investment income such as dividends, interest, or royalties) of over $2,000 for 2013 are subject to special rules. The purpose of the rules is to prevent shifting of income from parents to children to avoid tax at the parents' rate. The child's unearned income in excess of $2,000 for 2013 is subject to tax at the parents' tax rate, rather than the child's highest tax rate.

Passive Investments. California generally conforms to federal law (IRC Section 469) as that section read on January 1, 2009. Both state and federal law limit the ability of taxpayers to use passive investment losses to offset or shelter unrelated income. Passive investments are trade or business activities in which the taxpayer does not materially participate. Examples include investment in limited partnerships and other business entities; and rental activities. There is a limited exception for rental real estate activities where the taxpayer actively participates. A taxpayer may meet the requirement of active participation by participating in making management decisions or arranging for services provided by others. California has not conformed to the federal rules for "real estate professionals"; therefore, those taxpayers are still subject to the California passive loss rules.

State and federal laws require the segregation of income and deductions into "active", "passive", and "portfolio" categories. Portfolio income includes interest, dividends, royalties, and gain or loss for the disposition of assets providing portfolio income. Passive activity losses generally may not be deducted against other income, such as wages, salary or portfolio income, or business income that was not derived from passive activities. A similar rule applies to limit passive activity credits.

Current California law treats rental activities (including rental real estate activities) as passive activities, regardless of the level of taxpayer participation. Federal and California law permit the deduction of up to $25,000 of losses from rental real estate activities (even though considered passive) if the taxpayer actively participates in them and certain tests are met. This $25,000 amount is allowed for taxpayers with AGIs of $100,000 or less and is phased out for taxpayers with AGIs between $100,000 and $150,000. Deductions and credits suspended under these rules are treated as suspended losses or credits from a passive activity and can be carried forward to years in which there is passive income. Any remaining carry forwards is allowed in full when a taxpayer disposes of his or her entire interest in the passive activity to an unrelated taxpayer.

Taxpayers must adjust the amount of California passive activity losses for differences in other areas of state law (e.g., depreciation). Also, nonresidents and part-year residents must make adjustments to passive activity items in computing California source AGI.

Mandatory Electronic Payments. As of January 1, 2009, taxpayers subject to the Personal Income Tax Law are required to remit all payments electronically once an estimated tax or extension payment exceeding $20,000 is made, or upon the filing of an original return with a total tax liability over $80,000 for any taxable year that begins on or after January 1, 2009. Once the threshold is met, all subsequent payments regardless of amount, tax type, or taxable year must be remitted electronically. Individuals that do not send the payment electronically will be subject to a one percent noncompliance penalty. A taxpayer may request a waiver of the electronic payment requirement under certain circumstances. [AB 1389 (Assembly Budget Committee) Chapter 751, Statutes of 2008.]

Other Special Provisions That Affect Businesses. There are other special provisions in the Personal Income Tax Law that primarily affect business taxpayers. Several of these are described in the Corporation Tax chapter (Chapter 2C).

17. MINIMUM CORPORATE FRANCHISE TAX

Most corporations taxable by California are subject to a minimum franchise tax. This is a specified dollar amount that businesses must pay even if their tax liability based on net income is lower. See Section 4 of the Corporation Tax chapter (Chapter 2C) for more information on the franchise tax.

Personal income taxpayers are not subject to a minimum tax. However, certain entities taxed under the Personal Income Tax Law are subject to an annual tax equal to the minimum franchise tax. These include limited partnerships, limited liability partnerships, certain limited liability companies, and real estate mortgage investment conduits (REMICs).

18. LIMITED LIABILITY COMPANIES

A limited liability company (LLC) is a non-corporate entity, the revenue from which may be included as corporation tax revenue. An LLC provides its members with limited liability and the option to participate actively in the entity's management. An LLC is formed by filing Articles of Organization with the California Secretary of State. Although exhibiting the corporate characteristic of limited liability, an LLC with at least two members is usually treated as a partnership under the "check-the-box rules" used by both the Federal Government and California

In certain cases, an LLC may "check the box" on Federal Form 8832 (Entity Classification Election) to be taxed like a C Corporation. In addition, in certain cases, an LLC may "check the box" on Federal Form 2553 (election by a Small Business Corporation) to be taxed like an S Corporation. California applies the same tax treatment elected for federal tax purposes.

Under current state law, an LLC not classified as a corporation must pay the $800 annual LLC tax and the annual LLC fee if it is organized, doing business, or registered in California. Beginning in 2007, the annual LLC fee is based on the LLC's total income from all sources derived from or attributable to California. [AB 198 (Committee on Budget), Chapter 381, Statutes of 2007.] Total income is defined as the gross income, plus the cost of goods sold, that are paid or incurred in connection with the trade or business of the taxpayer attributed to California, determined by applying franchise and income tax sales factor rules under current law to the total income of the LLC. Prior to 2007, the annual LLC fee was based on the LLC's total income from all sources reportable to the state.[1] Total income excludes the flow-through of income from one LLC to another LLC if that income has already been subject to California's annual LLC fee. The following chart is used to compute the fee under the new law beginning 2007:

[---If Total California Annual Income Is---]

Equal To or Over ($)	But Not Over ($)	LLC Fee
$ 250,000	$ 499,999	$ 900
500,000	999,999	2,500
1,000,000	4,999,999	6,000
5,000,000	And Over	11,790

19. VOLUNTARY CONTRIBUTIONS

California allows taxpayers to make voluntary contributions of their own funds to one or more organizations listed on the state tax return by checking a box on their return. These eligible activities are often called "check-offs", although they are not like the federal check-offs that allow taxpayers to direct a portion of their tax liability to the selected organization. These contributions made on a California income tax return are deductible as charitable contributions on the following year's tax return for taxpayers that itemize deductions. The deductible amount of the contribution is the amount that exceeds the value of the benefit received, if any.

For the 2013 tax year, 20 check-offs will appear on the individual income tax form. The Legislature responded to the proliferation of check-offs on the tax form by requiring check-offs to have sunset dates and to meet minimum annual contribution amounts. The Legislature requires new check-offs to wait in line to be added to the form until old check-offs are removed (so-called 'queuing language'), or until the FTB determines there is room on the form. The current rules regarding the standards each check-off must meet in order to remain on the form are summarized in the following chart:

[1] Under prior law, total income was defined as gross income from whatever sources derived plus the cost of goods sold that are paid or incurred in connection with a trade or business. The law lacked a definition for "from all sources reportable to the state", but the FTB and taxpayers had defined this term to mean worldwide gross receipts without apportionment. However, this interpretation has been challenged.

VOLUNTARY CONTRIBUTION FUND INFORMATION

2012 California Personal Income Tax Return

VOLUNTARY CONTRIBUTION FUNDS	INITIAL TAX RETURN	FINAL TAX RETURN[1]	2012 MINIMUM CONTRIBUTION REQUIREMENT
Alzheimer's Disease/Related Disorders Fund	1987	2014	$347,328
American Red Cross, California Chapters Fund	2013	2018	No minimum requirements for 2013
California Breast Cancer Research Fund	1992	2017	$371,724
California Cancer Research Fund	2008	2017	$268,471
California Firefighters' Memorial Fund	1993	2015	No minimum requirement unless the repeal date is deleted
California Fund for Senior Citizens	1983	2014	$250,000
California Peace Officer Memorial Foundation Fund	1999	2015	No minimum requirement unless the repeal date is deleted
California Sea Otter Fund	2006	2015	$277,666
California Seniors Special Fund	1990	No Sunset	No minimum requirement
California YMCA Youth and Government Fund	2012	2016	$250,000
California Youth Leadership Fund	2012	2016	$250,000
Child Victims of Human Trafficking Fund	2011	2015	$254,250
Emergency Food For Families Fund	1998	2013	$360,179
Keeps Arts in Schools Fund	2013	2015	No minimum requirement for 2013
Municipal Shelter Spay-Neuter Fund	2011	2015	$254,250
Protect Our Coasts and Oceans Fund	2013	2018	No minimum requirement for 2013
Rare and Endangered Species Preservation Program	1983	2017	$324,972
School Supplies for Homeless Children Fund	2012	2016	$250,000
State Children's Trust for the Prevention of Child Abuse	1983	2017	$324,972
State Parks Protection Fund/Park Pass Purchase	2012	No Sunset	$250,000

[1]The final tax return is subject to change if the fund has a minimum contribution threshold it fails to meet or if legislation extends the repeal date. Dates and conditions of application vary for each fund.

Source: https://www.ftb.ca.gov/individuals/vcfsr/indvolcon.shtml

20. REVENUE

The personal income tax is the largest single source of revenue for the State of California. California revenues were $65.3 billion in 2012-13 (63% of state General Fund revenues). Revenues are expected to be $64 billion in 2013-14.

21. ADMINISTRATION

The FTB administers the personal income tax. Returns are due annually on the 15th day of the fourth month following the close of each taxable year (typically April 15th). Individuals are automatically granted an extended filing period of six months for submitting their tax returns but are not relieved of their obligation to pay the tax due by April 15. Taxpayers who do not pay 100% of their tax liability by April 15 owe interest and are assessed a late payment penalty. Similarly, taxpayers who do not file by the extended due date (typically October 15th) are assessed a penalty for failure to file. However, taxpayers who do file on or before the extended due date are not penalized for failure to file.

Salaries and wages are subject to withholding by employers. The Employment Development Department (EDD) administers withholding. If taxpayers have a significant amount of income that is not subject to withholding (such as from self-employment income or investments), they must pay estimated taxes in quarterly installments in order to ensure that they remit sufficient funds throughout the course of the year to avoid penalties for failure to timely pay. Taxpayers may be subject to penalties if amounts remitted over the course of the year through withholding and/or estimated payments are less than prescribed minimum percentages of their total tax liability.

The amount of tax due in excess of the amount withheld and/or paid as an estimated payment is due on April 15th. If a taxpayer overpays during the year through withholding and/or estimated payments, he or she can direct FTB to apply the overpayment to the next year's liability or to refund the overpayment by check.

22. CODE

California Constitution, Article III, Section 26

Revenue and Taxation Code, Division 2, Part 10, Section 17001 et. seq., and Part 10.2, Sections 18401-19802

CHAPTER 2C

CORPORATION TAX

HIGHLIGHTS

• Minimum Tax	$800 per year; except for new corporations.	
• Revenue*	2012-13 (Actual)	$7.5 billion
	2013-14 (Estimate)	$8.0 billion
	2014-15 (Estimate)	$8.7 billion
• Estimated Number of Returns Filed**	1,054,707 in tax year 2011	
• Administration	Franchise Tax Board (FTB)	

*Source: Governor's 2014-15 Budget Summary, Appendix 14, Schedule 8
**Franchise Tax Board

1. WHO PAYS THE CORPORATION TAX

The **corporation tax** applies to all corporations that earn income derived from or attributable to sources in California, except insurance companies. Professional corporations, benefit corporations, flexible purpose corporations, associations, certain trusts, partnerships and limited liability company(s) (LLCs) that elected to be taxed as corporations, banks, or financial institutions, such as savings and loan associations (thrifts), pay taxes under the Corporation Tax Law.

Nonprofit organizations are exempt from the corporation tax, except for income that is unrelated to their exempt purpose (see Section 1 of this chapter).

Insurance companies are exempted from the corporation tax (and most other state and local taxes) pursuant to the state Constitution. Instead, insurance companies are subject to a state gross premiums tax. (See Chapter 3C of this Reference Book for more information on the Insurance Gross Premiums Tax.)

Additional discussion about which corporations are subject to the corporation tax is provided in Section 4 below, entitled "Three Separate Taxes Comprise the Corporation Tax."

2. BENEFIT CORPORATIONS AND FLEXIBLE PURPOSE CORPORATIONS

Beginning on or after January 1, 2012, a new type of corporation called a "benefit corporation" can be formed with the purpose of creating general public benefit. An existing corporation can become a "benefit corporation", if certain procedures are followed. In addition, the "benefit corporation" can be created through a merger or reorganization.

Beginning on or after January 1, 2012, a new type of corporation called a "flexible purpose corporation" can be formed. An existing corporation can merge or convert into a "flexible purpose corporation". A "flexible purpose corporation" must have a special purpose which may include, but is not limited to, charitable and public purpose activities that could be carried out by a nonprofit public benefit corporation.

3. CALCULATION OF THE CORPORATION TAX

Taxpayers compute their tax liabilities based on income earned during the year. The year may be either a calendar year or a fiscal year commencing in any month except January, as specified by the taxpayer.

A brief summary of how tax is computed is as follows: Taxpayers must add up all sources of non-exempt income and subtract total deductions to which they are entitled, thereby arriving at "net income". They then apply the 8.84% tax rate to net income to determine the tax. Certain tax credits are allowed to reduce this tax, dollar for dollar. Also, corporate taxpayers may be liable for the alternative minimum tax.

The California corporation tax is similar, but not identical to, the federal income tax on corporations. Major differences are identified below.

When corporations do business both within and outside of California, it is necessary to determine what portion of total corporate income is taxable by California. This is done by means of formula apportionment, which is described in Chapter 2D, entitled "Determining the Income of Multistate and Multinational Corporations".

Refer to Chapter 2B on the Personal Income Tax for further information on taxes imposed on unincorporated businesses.

4. THREE SEPARATE TAXES COMPRISE THE CORPORATION TAX

There are three separate taxes levied under the umbrella of the state corporation tax:

- Corporation Franchise Tax. Every corporation doing business in California (regardless of location) is subject to the franchise tax. "Doing business" means "actively engaging in any transaction in California for the purpose of financial or pecuniary gain or profit."

The franchise tax is not a tax on income. Rather, it is a tax for the privilege of doing business in California measured by net income earned in California. Until changed by the Legislature in AB 1843 (Ackerman), Chapter 862, Statutes of 2000, a corporation paid the privilege tax for conducting business in the current year based upon (measured by) the corporation's income in the preceding year. As amended, the law requires a corporation to pay tax for the privilege of conducting business in this state for the current year based upon (measured by) the corporation's net income for the current year.

The majority of corporations taxed by California pay the franchise tax.

- Corporation Income Tax. Corporations deriving income from California sources but not sufficiently present to be classified as "doing business" in California are subject to the corporation income tax.

  This tax is nearly identical to the franchise tax. Because it is an income tax, however, interest from tax-exempt United States, California, or California municipality obligations is not included in income. Also, corporations are not subject to the minimum franchise tax.

  The most common situation where the corporation income tax is applied rather than the franchise tax is where a corporation operates in California through an agent or by using traveling salespersons, so the corporation does not have an established presence in the state. Another business entity commonly subject to the corporation income tax is a "business trust", which is a trust established for the purpose of making a profit (rather than for mere conservation of assets).

  Very few corporate taxpayers file under the corporation income tax.

- Bank Tax. Banks and financial institutions doing business in California are subject to an additional tax (known as the bank tax), which is levied in conjunction with the regular corporation tax. This tax is in lieu of personal property taxes and local business taxes, from which banks and financial institutions have been exempt since the enactment of the corporation tax in the 1930s.

  The bank tax rate is 2% and is designed to be equivalent to the average amount general corporations pay each year in personal property taxes and local business taxes (see below for a further discussion).

Federal law has a net income tax which applies to all corporate taxpayers, and does not have an add-on bank tax rate.

5. TAX RATES AND MINIMUM FRANCHISE TAX

The corporation franchise tax rate is the greater of 8.84% of net income, or the minimum franchise tax.

The minimum franchise tax is $800 and must be paid by any corporation subject to the franchise tax with a computed tax liability less than this amount. The $800 minimum franchise tax is not imposed for the first year a corporation is in existence. This corporation would, however, be subject to the 8.84% franchise tax rate on any net income.

The corporation income tax rate is 8.84% of net income. However, the minimum franchise tax does not apply.

The bank tax rate, which must be added to the franchise tax rate for banks and financial institutions, is statutorily set at 2%. Banks are subject to the minimum franchise tax if their computed tax from the combined corporate plus bank rate is less than $800. Federal corporate tax rates range from a low of 15% to a high of 35%. There is no minimum tax in federal law comparable to the state's minimum franchise tax.

6. INCOME AND DEDUCTIONS

Corporations begin computing their California tax by adding all sources of income, including income from business activities, dividends, interest, rents, royalties, gains from the sale of property, income from the discharge of debt, and so on. Unlike federal tax law, interest from federal, state and municipal obligations are included in total income under California franchise tax. For corporations, there are few exclusions from income or sources of exempt income (unlike those in the personal income tax).

The corporate tax is measured not by gross income, but by net income, which is what we commonly think of as business profit. In order to determine net income, corporations are allowed to deduct specified expenses from gross income.

The value of a deduction to a taxpayer, measured in terms of tax eliminated, generally may be estimated by multiplying the deduction by the tax rate. Therefore, the state tax savings to a corporation resulting from deducting a $1,000 expense is $88.40 ($1,000 expense x 8.84% state corporate tax rate).

The most important deductions available to corporations are described below. Unless noted otherwise, these are generally similar to deductions allowed to corporations in federal law.

- Trade or Business Expenses. Taxpayers are permitted to deduct the ordinary and necessary expenses of conducting a trade or business. Typical deductible expenses include compensation and fringe benefits for employees, the employer's portions of unemployment insurance and social security taxes, rent, utilities, advertising, and other similar current costs. Capital expenditures (that is, those that add to the value or useful life of property) cannot be deducted. Rather, they must be depreciated. (See Section 8 below.)

- Taxes. Corporations may deduct real and personal property taxes. Local, state, federal, and foreign income or profits taxes are not deductible. Sales taxes are also generally deductible; however, sales taxes incurred in the process of manufacturing or constructing property must be capitalized into the value of the property.

- Interest. In general, corporations may deduct all interest paid or accrued on business debts. While generally in conformity with federal law, California applies special rules to determine the interest expense of multistate and international corporations.

- Meals, Travel, Entertainment, and Private Club Expenses. Meal, travel, and entertainment costs are 50% deductible. Certain convention and cruise ship expenses are subject to special limitations. California conforms to the federal denial of club dues deductions.

- Charitable Contributions. Corporations may deduct the value of contributions to charitable or nonprofit organizations. The maximum deduction is 10% of net income; excess contributions may be carried over to the next five succeeding taxable years. Deductions for contributions of appreciated property (property that has increased in value) are generally limited to the basis (cost) of the property.

Various other (more specialized) deductions are available to corporations. Some of these deductions are described below.

7. DIVIDENDS RECEIVED DEDUCTION

Under present law, dividends received from general corporations may be eliminated if the corporation is a member of the taxpayers combined filing group.

Prior California law allowed corporate taxpayers a dividend received deduction (DRD) for dividends received from corporations that were not part of the taxpayer's filing group. The purpose of the DRD was to avoid double taxation by California on income reported at the corporate level. The payor of the dividend had to pay California tax on the income from which the dividend was paid. Without DRD relief, the corporation receiving the dividend included the dividend in income.

The DRD was computed as a percentage of the dividends received; the percentage varied depending upon the taxpayer's ownership interest in the payor corporation and whether the income of the payor corporation was subject to California income or franchise tax.

The DRD was authorized for payments made by general corporations in Revenue and Taxation Code (R&TC) Section 24402; the DRD was authorized for payments made by an insurance corporation in R&TC Section 24410.

The courts declared R&TC Sections 24402 and 24410 discriminatory against non-Californian businesses and, therefore, unconstitutional. [See *Farmer Bros. Co. v. Franchise Tax Board* (2003) 108 Cal.App. 4th 976, cert. denied 540 U.S. 1178, and *Ceridian Corp. v. Franchise Tax Board* (2000) 85 Cal.App. 4th 875 (modified 86 Cal.App. 4th 483).] The FTB, with concurrence from Legislative Counsel, holds that for taxable years beginning after December 1999, neither code section provides a DRD.

In 2004, the Legislature responded to the *Ceridian* decision with AB 263 (Oropeza), Chapter 868, Statutes of 2004. For taxable years beginning on or after January 1, 2004, corporations are allowed an 80% DRD (85% beginning in 2009) for dividends received from 80% or greater owned insurance companies. If the insurance company is overcapitalized (stuffed), the 80% DRD is phased out based on a "premiums-received-to-total-income-earned" ratio. For years beginning before January 1, 2004, the taxpayer may elect by March 28, 2004, to have the 80% DRD and phase out ratio apply. If a proper election is made, for taxable years beginning before 2004, the taxpayer may deduct expenses associated with earning the dividend income. AB 263 also contains other provisions addressing transactions between general corporations and insurance companies.

No legislation has been enacted that amends R&TC Section 24402, which previously allowed a DRD for dividends received from general corporations.

8. DEPRECIATION AND AMORTIZATION

Depreciation and amortization deductions allow taxpayers to recover capital investments in assets over the useful lives of those assets by deducting reasonable allowances for the exhaustion or wear and tear of the property. The idea behind depreciation is that, since capital assets are used over several years, the cost of acquisition is similarly deducted over several years (rather than all at once in the year in which the asset is purchased).

Depreciation and amortization are allowed for property, other than land, used in a trade or business or for the production of income (investment), including most kinds of tangible property and improvements to real property, farm buildings, machinery and other physical assets. Intangible assets that may be amortized include copyrights, licenses, franchises, goodwill, and covenants not to compete. Depreciation is not allowed for property used for personal purposes, inventory and stock in trade, land, and depletable natural resources. (See Section 9 on Depletion below.)

For corporation tax purposes, California generally does not allow use of the federal depreciation system called the Modified Accelerated Cost Recovery System (MACRS). Instead, California uses a depreciation system generally known as the Asset Depreciation Range (ADR) system, which is similar to that used in federal law for pre-1981 assets.

The ADR system generally requires the use of longer useful lives and fewer accelerated depreciation methods than would be allowed under the federal MACRS system.

Under the ADR system, assets are generally depreciated over the remaining useful life of the asset or over a designated "class life". Under this system, assets are grouped into more than 100 classes, and a guideline "life" for each class is established. For purposes of the ADR system, taxpayers may use a straight-line depreciation or certain rapid depreciation methods (such as double declining balance, 150% declining balance, sum-of-the-years-digits, or other consistent methods). The amount that is to be depreciated is the property's basis, which is typically its cost when acquired. Any depreciation that would be greater than that computed under the straight-line method is considered excess depreciation and is subject to the alternative minimum tax.

Effective for taxable years beginning on or after January 1, 2005 [AB 115 (Klehs), Chapter 691, Statutes of 2005], the Corporate Tax Law conforms to the Internal Revenue Code (IRC) Section 179 expensing provisions to the same extent under the Personal Income Tax Law. That is, a corporate taxpayer with a sufficiently small amount of annual investment is able to elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year in lieu of the current law "additional first-year depreciation" of up to $2,000. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. Prior to AB 115, only S corporations (see Section 11 of this Chapter) were permitted an IRC Section 179 deduction under the California tax law.

For the taxable year beginning before January 1, 2014, state law allows taxpayers doing business in certain economic incentive areas such as Enterprise Zones (EZs), Local Agency Military Base Recovery Areas (LAMBRAs), and Targeted Tax Areas (TTAs) to treat the cost of qualified property as an expense in the year the property is placed in service in the area. Current law (AB 93 and SB 90 (Stats. 2013, Ch.69 and 70)) repealed the economic incentive areas and added a new employment credit. The new credit is discussed in the credits section below.

9. DEPLETION

California closely conforms to federal law in the area of depletion deductions. Depletion deductions allow owners of natural resources to recover the costs of the resource as it is extracted, harvested, or otherwise diminished. Depletion is to the owner of an oil or gas well or mineral or timber property what depreciation is to the owner of a capital asset.

Depletion deductions are allowed to any taxpayer with an economic interest in a property containing depletable resources. Two alternative depletion computations are provided in both state and federal law. The taxpayer must compute the depletion amount both ways and may deduct the larger amount. The two methods are:

- <u>Cost Depletion</u>. Cost depletion requires the taxpayer to estimate the yield of the resource (e.g., 10 million barrels of oil). Then, the cost associated with extracting the resource is divided by the number of units. The resulting quotient is the cost depletion per unit. That amount multiplied by the number of units extracted and sold during the year determines the cost depletion that is deductible for the year. Each year, the cost basis of the property is reduced by the amount of depletion deducted for that year until the entire cost basis has been deducted. At that point, no additional cost depletion is allowed.

- Percentage Depletion. Most depletable property qualifies for this alternate computation method. However, it is not available for timber. Under percentage depletion, a flat statutorily set percentage of annual gross income from the natural resource property is taken as the depletion deduction each year. Thus, the deduction bears no relationship to the actual amount of the resource extracted during the year. However, the laws set an upper limit on the deduction of 50% of the taxable income from the property (100% for oil and gas properties).

10. CARRYOVER OF NET OPERATING LOSSES

Businesses incur "net operating losses" (NOLs) for tax purposes when allowable deductions exceed gross income. When deductions are less than gross income, the business has net income (i.e., shows a profit). A business may show a net operating loss for tax purposes without incurring actual out-of-pocket losses, due to the allowance of tax deductions for items that may not be actual out-of-pocket expenses, such as carryforward of deductions from prior years and depreciation.

In a year when a business shows a net operating loss for tax purposes, the business is not required to pay any corporation taxes beyond the minimum franchise tax.

Similar to federal law, California law generally allows businesses with NOLs to carry over these losses and deduct them against income earned in future years.

For tax years beginning on or after January 1, 2004, and before January 1, 2008, state law allows the following NOLs:

NOL TYPE	NOL % ALLOWED TO BE CARRIED OVER	CARRYOVER PERIOD
General NOL	100%	10 Years
Specified Disaster Loss	100%	15 years
Pierce's Disease	100%	9 Years
Economic Development Areas	100%	15 Years

In 2008, the following changes were made to NOLs:

- NOL deductions were suspended for taxable years beginning on or after January 1, 2008, and before January 1, 2010, for a corporation with net business income subject to tax of $500,000 or more.

- NOL deductions were suspended for taxable years beginning on or after January 1, 2010 and before January 1, 2012, for a corporation with pre-apportioned income after state adjustments of $300,000 or more.

- The NOL carryover period is extended by four years for NOLs attributable to tax years beginning before January 1, 2008, three years for NOLs incurred in taxable year 2008, two years for NOLs incurred in taxable year 2009, and one year for NOLs incurred in taxable year 2010.

- The NOL carryover period is extended to 20 years for NOLs attributable to taxable years beginning on or after January 1, 2008.

- California conforms to the federal NOL carryback rules for NOLs attributable to taxable years beginning on or after January 1, 2013, with the following modifications:

  - An NOL may be carried back only two years. (Federal law has special rules that in some cases allow an NOL to be carried back for a longer period).

- The carryback amount of an NOL attributable to taxable year 2013 is limited to 50% of the net operating loss.
- The carryback amount of an NOL attributable to taxable year 2014 is limited to 75% of the net operating loss.
- California conforms to the federal carryback period for a Real Estate Investment Trust (REIT) and a corporate equity reduction interest loss, which is zero.

11. TREATMENT OF S CORPORATIONS

"S corporations" are named for a subchapter of federal income tax laws (United States Code, Title 26, Subchapter S) that grant certain corporations special tax treatment.

As defined by federal law, S corporations are domestic corporations with 100 or fewer shareholders, only one class of stock, no shareholders other than individuals, estates, trusts, and certain exempt organizations, and not a member of an affiliated group. In general, S corporations must be involved in an active trade or business and are limited with respect to the amount of passive investment income from royalties, dividends, and interest they may receive. Corporations that meet these definitions may elect to be exempt from the federal corporate tax, and instead pass through the corporation's taxable income to its individual shareholders.

A corporation's California tax status must be the same as its federal tax status is. That is, a corporation that elects to be taxed as an S corporation for federal purposes must be taxed as an S corporation for California tax purposes. Similarly, a corporation cannot be an S corporation for California tax purposes unless it has a valid federal S election in place.

Once a business elects S corporation status, its corporate income is taxed at a rate of 1.5% instead of the normal 8.84%, and credits are limited to one-third of the C corporation credit amounts. One hundred percent of the corporation's items of income, loss, deduction, and credits are passed through to the shareholders in accordance with their respective interests in the corporation.

Federal and state laws permit S corporations to own 100% of another domestic corporation and to make an election to treat the owned corporation as a Qualified Subchapter S Subsidiary (QSub). All of the activities, assets, liabilities, income, deductions, and losses of the QSub are treated as the activities, assets, liabilities, income, deductions, and losses of the parent S corporation. The parent S corporation pays tax on the entire amount of income reported and passes the full amount through to its shareholders. California law imposes a tax equal to the minimum franchise tax to the QSub.

Under California law, S corporations are permitted to use the MACRS depreciation system (described in Section 8 of this chapter) rather than the ADR system. In addition, California S corporations are not subject to the alternative minimum tax. (See Section 14 of this chapter.)

12. CAPITAL GAINS AND LOSSES

Capital gains are profits from the sale of property and other capital assets. Capital assets are defined as all property except the following: inventories, property held for sale in the ordinary course of business, depreciable business property, and real property used in business. Capital assets include real property (land and buildings), personal property, and intangible assets (such as stock).

Capital gains are measured as the difference between the amount realized when the asset is sold and the asset's basis (normally the original purchase price). Any amounts invested in improvements are added to the basis; costs of the sale are deducted from the sales price. The gain is generally recognized in the year the asset is sold or exchanged.

Capital gains classified as a different type of income from the "ordinary income" of a corporation arising from its trade or business activities. Under both federal and California law, corporate capital gains are taxed the same as ordinary income; that is, they are fully includible in income subject to tax. Under California and federal law, corporate capital losses may be fully deducted against capital gains, but excess capital losses cannot be deducted against ordinary income. Both California and federal law provide that these excess losses may be carried forward for five years and deducted against capital gains in future years. Both laws allow 100% capital loss carryforwards. Federal law permits a three-year carryback in addition to the carryover.

13. TAX CREDITS

Tax credits reduce tax liability dollar for dollar, but not below the annual minimum tax, if applicable. Thus, they operate differently from deductions, whose value in reducing tax liability equals the amount of the deduction multiplied by the highest marginal tax rate to which the taxpayer is subject. (See Section 6 of this chapter.)

Tax credits available under the corporation tax are intended to provide businesses incentives to engage in certain activities that are socially or economically desirable. Most credits are also available to businesses that file under the Personal Income Tax Law. The amount of tax credits allowable in any taxable year may be limited by the taxpayer's alternative minimum tax liability or by tentative minimum tax. (See Section 14 of this chapter for further information.)

Some of the tax credits allowed in state law are similar to credits offered in federal law. However, in most cases, the federal credit amounts are greater because the federal tax burden is approximately four times greater than California's. This can be seen by comparing the rate structures: California's corporate rate is 8.84%, while the top federal corporate rate is 35%. As a result, many state income tax credits patterned after federal credits are roughly one-fourth the size of the federal credit.

2008-2009 Credit Limitation. For taxable years beginning on or after January 1, 2008 and before January 1, 2010, business credits are limited for taxpayers with income subject to tax greater than $500,000. Total business credits are limited to 50% of tax (before the application of credits). The carryover period for any credit that is limited is increased by the number of taxable years the credit (or any portion thereof) is not allowed.

Credit Assignments. Effective for taxable years beginning on or after July 1, 2008, a member of a combined reporting group, when certain conditions are met, may make an irrevocable assignment of a credit or available credit carryover to another member of the combined reporting group. Assigned credits may be used to reduce tax in taxable years beginning on or after January 1, 2010.

Several of the major credits in California Corporation Tax Law are described below:

Donated Agricultural Product Transportation Credit. Taxpayers may claim a tax credit equal to 50% of the costs for transporting donated agricultural products to a nonprofit organization.

Upon receipt or delivery of the donated agricultural product, the nonprofit organization must provide the transporter a certificate signed and dated by an authorized representative of the organization. The certificate must state the name and address of the recipient organization, the type and quantity of the product donated, the distance the product was transported, the name of the transporter and the taxpayer donor, and that the product was donated pursuant to the Food and Agriculture Code. The taxpayer must provide a copy of the certificate to the FTB upon request.

The agricultural products transportation credit applies to taxable years beginning on or after January 1, 1996. This credit may be carried over until exhausted and may not reduce the tax below tentative minimum tax for AMT purposes.

Donated Fresh Fruits or Fresh Vegetables Credit. Qualified taxpayers may claim a credit equal to 10% of the costs of fresh fruits or fresh vegetables donated to a California food bank.

A "qualified taxpayer" is defined as the person responsible for planting the crop, managing the crop, and harvesting the crop from the land. The cost of donated fresh fruits or fresh vegetables is the cost of those products that would otherwise be included in inventory costs. Generally, inventory costs would include both the direct costs and the allocated indirect costs required to produce the fresh fruits or fresh vegetables. Because inventory costs are costs of doing business, the credit is available only to a business that is also a qualified taxpayer.

The recipient of a donation of fresh fruits or fresh vegetables must provide to the donor certification of the type and quantity of the products donated, the name of the donor or donors, the name and address of the donee nonprofit organization, and, as provided by the donor, the estimated value of the donated products and the location where the donated product was grown. A donor that is a qualified taxpayer must provide a copy of the certificate to the FTB upon request.

The fresh fruits and fresh vegetables credit applies to taxable years beginning on or after January 1, 2012, and before January 1, 2017. This credit may be carried forward for up to six years and may not reduce the tax below tentative minimum tax for AMT purposes.

Farmworker Housing Credit. Beginning January 1, 2009, the standalone Farmworkers Housing Credit (FWHC) discussed below was repealed [SB 1247 (Lowenthal), Chapter 521, Statutes of 2008], and is now incorporated within and required to be administered as part of the Low-Income Housing Credit (LIHC) program.

For both personal income and corporation taxpayers, California law allowed a 50% credit for the qualified costs of construction or rehabilitation of qualified farmworker housing beginning January 1, 1997.

For banks and financial corporations, California law also allowed a 50% credit on below-market rate loans used to finance the construction or rehabilitation of qualified farmworker housing. The credit equaled 50% of the difference between the amount of interest income that would have been collected by a bank or financial corporation had the loan rate been one point above prime and the lesser amount of interest income actually due for the term of the loan.

The aggregate amount of both credits available for allocation could not exceed $500,000 for any taxable year. However, any unallocated credits left over during one year was able to be carried forward for allocation during subsequent years.

Disabled Access Credit. For both personal income and corporation taxpayers, California law allows a 50% credit to eligible small businesses for expenses incurred up to $250 to comply with the federal Americans with Disabilities Act of 1990. The disabled access credit applies to taxable years beginning on or after January 1, 1996 and continues indefinitely. This credit may be carried over until exhausted and may not reduce the tax below tentative minimum tax for AMT purposes. There is also a comparable federal credit.

Enhanced Oil Recovery Credit. Federal law allows taxpayers an enhanced oil recovery credit that is combined with several other credits to form the general business credit.

This credit is allowed in an amount up to 15% of the taxpayer's qualified enhanced oil recovery costs. The qualified costs are defined as amounts paid or incurred for qualifying tangible property that may be depreciated or amortized and are an integral part of a qualified enhanced oil recovery project involving one or more tertiary recovery methods.

If a credit is allowed for these costs, the amount otherwise deductible or required to be depreciated or recovered through depletion must be reduced by the amount of the allowable credit.

The California enhanced oil recovery credit amount is one-third of the taxpayer's allowed federal enhanced oil recovery credit. The state credit applies only to oil recovery projects located within California.

A taxpayer's election not to take the credit for federal purposes prevents the taxpayer from claiming a state credit.

The enhanced oil recovery credit applies to taxable years beginning on or after January 1, 1996 and continues indefinitely. This credit may be carried over for up to 15 years and may not reduce the tax below tentative minimum tax for AMT purposes.

Community Development Financial Institution Deposit Credit. Under the Corporation Tax Law and the Personal Income Tax Law, a credit is allowed for 20% of the amount of each "qualified deposit" into a "community development financial institution" (CDFI). A qualified deposit is defined, as is equal to or greater than $50,000 and made for a minimum duration of 60 months. A CDFI is defined as a private financial institution located in California and certified by the California Organized Investment Network (COIN) as an entity with community development as its primary mission. CDFIs may lend in urban, rural, or reservation-based communities in California. A CDFI may include a community development bank, a community development loan fund, a community development credit union, a micro-enterprise fund, a community development corporation-based lender, and community development venture fund.

The aggregate amount of qualified deposits made by all taxpayers is limited to $50 million for each calendar year, thus limiting the value of the credit to $10 million annually.

Any previously allowed credit will be recaptured if the qualified deposit is withdrawn before the end of the 60th month and not re-deposited or reinvested in another CDFI within 60 days. However, the recapture penalty is lower if the full amount invested is not withdrawn. An amount equal to 20% of any reduction in the qualified deposit will be recaptured if the qualified deposit is reduced before the end of the 60th month, but not below $50,000.

This credit is effective for taxable years beginning on or after January 1, 1997 and before January 1, 2017. This credit may be carried over for up to four years and may not reduce the tax below tentative minimum tax for AMT purposes.

Employer-Provided Child Care. The Employer-Provided Child Care Credit discussed below was repealed by its own terms on December 1, 2012 and any unused credits can be carried over until exhausted.

California allowed credits to employers under both the personal income tax and the corporation tax for providing child care services to their employees.

Specifically: (a) a 30% credit was allowed to employers or building owners for the costs of start-up expenses related to establishing or expanding a child care program or constructing an on-site or near-site child care facility for employees' or tenants' dependents; (b) a 30% credit was allowed for employer costs to operate child care information and referral services, with a maximum dollar credit; and (c) a 30% credit was allowed for employer contributions to child care arrangements for employees' children under the age of 12, such as on-site service, center-based service, home provider care or in-home care; this credit could not exceed $360 per year per child. Only amounts paid directly by employers to child care providers qualify for the credit. There are no comparable federal credits.

Low-Income Housing Construction and Rehabilitation. California allows a tax credit against the personal income tax, corporation tax, and insurance gross premiums tax for construction or rehabilitation of low-income housing in California. The credit is equal to 30% of amounts invested and is claimed over four years (9%, 9%, 9%, and 3%). Except in certain cases, it is available in addition to the comparable credit offered under federal law (9% annually for 10 years for nonsubsidized housing, 4% annually for 10 years for subsidized housing).

To qualify for the state credit, a taxpayer must receive an allocation from the Tax Credit Allocation Committee, and the rents must be maintained at low-income levels for 30 years (compared to 15 years for the federal credit). For buildings located in certain areas or census tracts, the federal credit must be reduced for the state credit to be claimed.

Corporations may elect to assign any portion of the credit to an affiliated bank or corporation. This credit can reduce regular tax below tentative minimum tax. The state credit will remain in effect as long as the federal credit remains in effect. The federal credit was made permanent by the Revenue Reconciliation Act of 1993. Federal law provides more than $50 million in credits annually to California. California offers $70 million in state credits.

Beginning January 1, 2009, and before January 1, 2016, the LIHC (other than LIHC for farmworker housing) can be allocated to the partners of a partnership owning a low-income housing project, in accordance with a partnership agreement, regardless of how the federal LIHC is allocated to the partners or whether the allocation of the credit under the terms of the agreement has substantial economic effect [SB 585 (Lowenthal), Chapter 382, Statures 2008].

Beginning January 1, 2009, the standalone FWHC discussed above was repealed [SB 1247 (Lowenthal), Chapter 521, Statutes 2008], and is now incorporated within and required to be administered as part of the LIHC program. The annual cap remains at

$500,000 plus any unallocated credits under prior law. Any FWHC that is unallocated or returned is to be added to the annual credit allocation cap until exhausted.

Research Expenditures. California allows a tax credit under the personal income tax and the corporation tax for incremental research expenditures made during the year. For taxable years beginning on or after January 1, 2009, California conforms to the federal research credit as of the "specified date" of January 1, 2009, with significant modifications. California specifically does not conform to the federal research credit termination date; thus, unlike the federal credit, the California research credit is permanent. Other California modifications are discussed below.

California Credit Percentages. California modifies:

1) The federal 20% general credit to be 15% of qualified expenses; and,

2) The federal 20% university "basic research" credit to be 24% of qualified expenses.

California Research. The terms "qualified research" and "basic research" include only research conducted in California. In computing gross receipts under IRC Section 41(c)(5), only gross receipts from the sale of property held for sale in the ordinary course or business, that is delivered or shipped to a purchaser within California, will be included. Qualified research expenses are modified to exclude any amount paid or incurred for tangible personal property that is eligible for the exemption from sales or use tax under R&TC Section 6378.

University "Basic Research" Expenses. Similar to federal law, only corporations qualify for the credit for the university "basic research" credit. However, California modifies "basic research" to include any basic or applied research including scientific inquiry or original investigation for advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, except the term does not include any of the following:

1) Basic research conducted outside California;

2) Basic research in social sciences, arts or humanities;

3) Basic research for purposes of improving a commercial product if the improvements relate to style, taste, cosmetic, or seasonal design factors; or,

4) Any expenditure paid or incurred to ascertain existence, location, extent, or quality of any deposit of ore or other mineral, including oil or gas.

Alternative Incremental Research Credit. For taxable years beginning on or after January 1, 2010, California conforms to the alternative incremental credit as of the "specified date" of January 1, 2009, with modifications. For California purposes, the federal credit rates of 3%, 4%, and 5% are modified to be 1.49%, 1.98%, and 2.48%, respectively, and the alternative incremental credit may no longer be elected in taxable years beginning on or after January 1, 2010.

Alternative Simplified Credit. California specifically does not conform to the alternative simplified credit.

Eligible Expenses. California generally conforms to the federal rules for eligible expenses, but does not conform to the special rules that allow qualified research expenses to include 100% of amounts paid or incurred by the taxpayer to an eligible small business, university, or federal laboratory for qualified energy research.

Enterprise Zones (EZs), Targeted Tax Areas (TTAs), Manufacturing Enhancement Areas (MEAs), and Local Agency Military Base Recovery Areas (LAMBRAs) Incentives. For taxable years beginning before January 1,2014, California provided an array of tax incentives to businesses and their employees located in designated EZs, TTAs, MEAs and LAMBRAs. These designated zones and areas are economically depressed areas of the state designated by the Department of Housing and Community Development. Special incentives include:

- For EZs. A tax credit for sales or use taxes paid on the purchase of qualified machinery and machinery parts, (which can reduce regular tax below tentative minimum tax (TMT)); a tax credit to employers for wages paid to qualified employees working in the zone (which can also reduce regular tax below TMT); a tax deduction for net interest income arising from loans made to zone businesses; and expensing of all or part of the cost of qualified property.

- For TTAs. A tax credit for sales or use taxes paid on the purchase of qualified machinery and machinery parts, a tax credit for wages paid to qualified employees working in the targeted tax area, and expensing of all or part of the cost of qualified property. Both credits can reduce regular tax below tentative minimum tax.

- For MEAs. A credit for wages paid to qualified employees working in the MEA.

- For LAMBRA. A tax credit for sales or use taxes paid on the purchases of qualified machinery and machinery parts; a tax credit to employers for wages paid to qualified employees working in the area; and expensing of all or part of the cost of qualified property.

These tax advantages can be generated for taxable years beginning before January 1, 2014, and are available during the 15-year life of each designated EZ, TTA, or MEA, and during the eight-year life of each designated LAMBRA. Federal law provides limited benefits to a very small number of "Empowerment Zones" and "Enterprise Communities". Some of these federal zones partially overlap California's geographicallybased economic incentive areas. Regions of overlap include Los Angeles, Santa Ana, San Diego, San Francisco, Oakland, Imperial County, Watsonville, and Fresno.

Prior-Year Alternative Minimum Tax (AMT) Credit. While the AMT ensures that a taxpayer's tax liability is not reduced to zero by tax preferences, the purpose is not to eliminate the use of the tax preferences, but to defer them. (See Section 14 for a discussion of the AMT.) The prior-year AMT credit is allowed for AMT paid in a prior year by taxpayers that are not liable for AMT in the current year. The amount of the allowable credit in any tax year is limited to the regular tax less the refundable credits (with no carryover provisions and the credit for taxes paid to other states). The credit may be claimed by both personal income and bank and corporation tax filers.

Prison Inmate Labor. A credit is allowed for 10% of the amount of wages paid to each prisoner employed in a joint venture pursuant to an agreement with the Director of Corrections.

New Jobs Tax Credit. California allows a New Jobs Tax credit, for taxable years beginning on or after January 1, 2009 and before January 1, 2014, to a qualified employer in the amount of $3,000 for each qualified full-time employee hired in the taxable year, determined on an annual full-time equivalent basis. The credit is allocated by the FTB and has a cap of $400 million for all taxable years. The credit remains in effect until December 1 of the calendar year after the year in which the cumulative credit limit has been reached and is repealed as of that date. Any credits not used in the taxable year may be carried forward up to eight years.

New Employment Credit. For taxable years beginning on or after January 1, 20114, California allows a New Employment Credit to qualified employers, paying qualified wages, to qualified employees. The credit is equal to 35% of the amount of wages paid between 150% and 350% of minimum wage. The credit may be generated up to five consecutive years for the same employee as long as the employee remains employed. Any credits not used in the taxable year may be carried forward for up to five years.

California Competes Credit. For taxable years beginning on or after January 1, 2014 and before January 1,2025, California allows a California Competes credit to be allocated to chosen California companies. The amount of the credit and the companies chosen to receive the credit would be determined by a California Competes committee, "Go-Biz". Go Biz will ensure that the aggregate credit amount allocated to all companies does not exceed $30,000,000 for the 2013-14 fiscal year; $150,000,000 for the 2014-15 fiscal year; and $200,000,000 for each fiscal year from 2015-16 to 2017-18, inclusive. The amount available to be allocated in any given fiscal year may be adjusted if the amount available in a prior year was not allocated, or an amount allocated was recaptured, or if the Department of Finance determines that the amount allocated under this credit, the New Hiring Tax Credit, and manufacturing sales and use tax exemption exceeds $750,000,000 in specified fiscal years.

14. ALTERNATIVE MINIMUM TAX (AMT)

Corporate taxpayers that take advantage of certain tax preferences (exemptions, deferrals, or deductions) must compute an AMT at a 6.65% rate (C corporations) or 8.65% rate (for banks and financial institutions) and pay this if it exceeds the amount of regular tax due. The purpose of the AMT is to ensure that taxpayers who take advantage of special tax reduction provisions in the tax code pay at least some minimum amount of tax on income receiving preferential treatment. These AMT rules generally conform to federal law, which imposes the corporate AMT at a 20% rate.

Computation of the AMT is rather complex. In simplified terms, the taxpayer is required to first compute the regular tax, using the rules described in this chapter and applying the regular corporate rate of 8.84%. Then the taxpayer must compute the "tentative minimum tax," which is calculated by including more income and by adding back certain tax preferences that were claimed during the first calculation, then subtracting an exemption amount ($40,000 for corporations) and applying the AMT rate of 6.65% (for C corporations) or 8.65% (for banks and financial institutions) to the difference. If the "tentative minimum tax" is higher than the computed regular tax, then the difference is the AMT due, which must be paid in addition to the regular tax.

A simple example of this procedure is shown in Table 5.

These rules for corporations generally apply to personal income taxpayers as well.

AMT has an important interaction with tax credits. Most credits can reduce regular tax down to, but not below, TMT. However, specific credits are available to reduce regular tax below TMT to determine a taxpayer's regular tax liability. These credits include:

- Enterprise zone hiring credit;
- Enterprise zone sales or use tax credit;
- Los Angeles Revitalization Zone (LARZ) construction hiring credit carryover;
- LARZ hiring credit carryover;
- LARZ sales or use tax credit carryover;
- Low-income housing credit;
- Manufacturers' investment credit carryover.
- Program area hiring credit carryover;
- Program area sales or use tax credit carryover;
- Research and development credit;
- Solar energy credit carryover; and,
- Targeted Tax Area hiring credit.
- Motion Picture and Television Production credit.

In addition, the solar energy credit carryover and commercial solar energy credit carryover can reduce a taxpayer's alternative minimum tax liability.

TABLE 5

EXAMPLE: COMPUTATION OF ALTERNATIVE MINIMUM TAX (AMT) FOR A HYPOTHETICAL CORPORATION

Regular Tax Computation:

1) Income of $500,000 less deductions of $300,000 =
   Net Income of $200,000 times 8.84% rate =

   Regular Tax of $17,680

2) Tentative Minimum Tax Computation:

   Income of $500,000 less deductions of $300,000
   plus income adjustments of $50,000 plus tax preferences added back of $100,000 =
   Alternative Minimum Taxable Income of $350,000 *less* exemption of $40,000 =
   $310,000 times 6.65% rate =

   Tentative Minimum Tax of $20,615

3) **Difference** between Tentative Minimum Tax and Regular Tax
   [$20,615 less $17,680] =

   AMOUNT of . . . .$ 2,935

4) Total Tax Computation:

   Regular Tax plus AMT [$17,680 plus $2,935] =

   Total Tax Liability of $20,615

Tax preference items and required adjustments are generally similar to those in federal law. Specific rules for computing each of these are provided in the law.

15. TAX EXEMPT ORGANIZATIONS

In 2013, approximately 189,000 organizations filed returns as exempt from the corporation tax. In general, these organizations can be described as nonprofit educational, religious, charitable, literary, scientific, civic, fraternal, and social organizations. State and federal rules for qualifying as a tax-exempt organization are nearly identical.

There are restrictions on the amount of lobbying in which such organizations may engage and retain their tax-exempt status.

Certain nonprofit business and labor organizations, chambers of commerce, real estate boards, cemeteries, certain political organizations, and various beneficiary and retirement organizations may qualify for tax exempt status.

Almost all organizations that are exempt from the corporation tax nonetheless are subject to tax on "unrelated business income" (UBI) in excess of $1,000 per year. The UBI is income from a trade or business activity that is regularly carried on and is not related to the organization's exempt purpose. The tax rate on UBI is the regular corporate rate of 8.84%. Businesses that are taxed on UBI are not subject to the minimum franchise tax.

16. REVENUE

The corporation tax is the third largest source of General Fund revenue. In fiscal year (FY) 2012-13 it generated approximately $7.5 billion.

17. ADMINISTRATION

The FTB administers the corporation tax, and also is charged with setting the bank tax rate each year.

For taxable years beginning on or after January 1, 2010, estimated payments of tax liability are due as follows:

○ 1st quarter installment	30% of estimated tax
○ 2nd quarter installment	40% of estimated tax
○ 3rd quarter installment	0% of estimated tax
○ 4th quarter installment	30% of estimated tax

Corporate taxpayers who are not required to make an estimate payment installment in the first quarter are required to make the following installment payments in subsequent quarters:

○ 2nd quarter installment	60% of estimated tax
○ 3rd quarter installment	0% of estimated tax
○ 4th quarter installment	40% of estimated tax

Corporate taxpayers who are not required to make an estimate payment installment in the first two quarters are required to make the following installment payments in subsequent quarters:

○ 3rd quarter installment	70% of estimated tax
○ 4th quarter installment	30% of estimated tax

Corporate taxpayers who are not required to make an estimate payment installment in the first three quarters are required to pay 100% in the fourth quarter.

Returns are due on the 15th day of the third month following the close of the taxable year. Taxpayers are subject to penalties if estimated payments remitted over the course of the year are less than prescribed minimum percentages of tax liability.

Taxpayer appeals of disputed tax assessments are made first to the FTB, then to the Board of Equalization (BOE). After payment, taxpayers may appeal in the courts.

Taxpayers may post deposits with the FTB in lieu of paying disputed tax assessments. Taxpayer appeals of denied refund claims may be made either to the BOE or in state court.

The paperless automatic extension program, similar to the program for personal income taxpayers, grants a seven-month automatic extension of time to file the tax return for all corporations that are not suspended. California banks and corporations are still required to pay 100% of the current tax liability by the 15th day of the third month following the close of the taxable year. Taxpayers who owe additional tax would be required to send in their payment coupon by their original due date.

As under current law, taxpayers who do not pay 100% of the tax liability by their original due date will owe interest and will be assessed the late-payment penalty. A return filed by the extended due date, with or without 100% of the tax liability paid by the original due date, will be considered to be a timely-filed return.

Electronic Funds Transfer Requirement. Taxpayers subject to the Corporation Tax Law and that meet certain requirements must pay all tax liabilities, both estimated payments and any tax due with the return, via electronic funds transfer.

In general, taxpayers subject to Corporation Tax Law must pay via electronic funds transfer if any quarterly estimated tax payment exceeds $20,000 or their total tax liability exceeds $80,000. In addition, any taxpayer may use electronic funds transfer if the FTB grants permission to a request from the taxpayer.

18. CODE

California Constitution, Article XIII, Sections 26 and 27

Revenue and Taxation Code, Division 2, Part 10.2, Sections 18401-19802 and Part 11, Sections 23001-25141

CHAPTER 2D

DETERMINING THE INCOME OF MULTISTATE AND MULTINATIONAL CORPORATIONS

HIGHLIGHTS

- Unitary Corporations
- Combination
- Apportionment Formula
- Worldwide Combination
- Water's-Edge Combination
- Business Versus Nonbusiness Income
- Federal Treatment of Multinational Corporations

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1. INTRODUCTION

When a corporation derives income from sources both within and outside of California, it is necessary to determine what portion of total corporate income is earned in California and is subject to tax in this state.

The method used by California and many other states is called the "unitary method." It applies to both multistate and multinational corporations.

The unitary method was developed early in the history of state corporate taxation as an alternative to the so-called "source method", which attempts to identify the geographic source of each corporate income stream. The source method is inadequate because it failed to reflect that a corporation's income is earned as the result of all its activities in all locations. An attempt to identify one geographic source of the earnings does not accurately reflect the contribution of all corporate activities to the ultimate profitability of the company. In addition, the source method is inadequate because multistate and multinational corporations have the ability to manipulate their internal accounts so as to shift profits earned in California or another high tax state into a state with low or no taxes on corporate income (or conversely, shift losses to high tax states).

In contrast, the unitary method combines total corporate income, then uses a formula to apportion total income to the taxing jurisdictions within which the corporation does business. This method has the advantages of reflecting the contribution of all corporate activities to overall profit, and of making the assignment of income and expenses to divisions within the corporation, or to particular geographic locations, irrelevant to the determination of tax liability.

The use of the unitary method by states has been quite controversial over the years. Most of the controversy has centered on the application of the unitary method to multinational corporations. In general, use of the unitary method to apportion income of multistate corporations operating only in the United States has received relatively little challenge. Further discussion of the controversy surrounding worldwide combination and apportionment is provided in Section 5 of this chapter.

The unitary method is a very complex area of tax law, and it has developed over the years through statutory provisions, regulations of the Franchise Tax Board (FTB), decisions on taxpayer appeals by the quasi-judicial Board of Equalization (BOE), and judicial decisions in both state and federal courts. This area of law is still evolving.

2. UNITARY CORPORATIONS

The unitary method applies to single corporations doing business both within and outside of California. It also applies to groups of affiliated corporations that, in effect, operate as one integrated business. When a group of corporations operates as a "unit" (i.e., is 'unitary'), that group is treated as if it were one corporation and is subject to the unitary method.

A single corporation or a group of affiliated corporations may conduct more than one unitary business. In those circumstances, each unitary business is accounted for separately. A corporation may also have "investment" activities that are accounted for separately from the unitary business. (See Section 7 below on Business versus Nonbusiness income.)

Whether a group of corporations comprise a unitary group is a complex determination that must be made based on the facts and circumstances of each corporate group. This is also an area where the law is still developing. Taxpayers and the FTB determine whether a group of affiliated corporations is unitary by means of three general tests that have grown out of a body of judicial opinions. These are (a) the three unities test, (b) the contributions and dependency test, and (c) the functional integration test. A unitary business exists if any of the three tests is met. In the three unities test, the relevant unities are: unity of ownership, unity of operation, and unity of use. Important facts considered for each test of unity are:

- Unity of Ownership. This exists where the same interests own, directly or indirectly, more than 50% of the voting stock of all members of the group. Unity of ownership may also exist between:

  a) A parent corporation and one or more other corporations if the parent owns stock representing more than 50% of the voting power of at least one corporation in the group and, if applicable, stock cumulatively representing more than 50% of the voting power of each of the corporations (except the parent) is owned by the parent or two or more members of the group.

  b) Any two or more corporations if stock representing more than 50% of the voting power of the corporations is owned (directly or by constructive ownership) by a single person.

  c) Any two or more corporations if stock representing more than 50% of the voting power of the corporations is owned (directly or by constructive ownership) by two or more members of the same family.

  d) Any two or more corporations that constitute stapled entities.

- Unity of Operation. Is usually shown by centralized operations or functions such as purchasing, advertising, accounting and management. In some instances, corporations that are neither in the same line of business nor vertically integrated are found to be unitary because of centralized management and central departments.

- Unity of Use. Is reflected by a centralized executive force and the operation systems in general.

3. COMBINATION

Once it is determined that a unitary business conducts unitary activities both within and outside of California, all income and deductions from the separate sites are combined. The group computes net income as if it were a single corporation. Income and expenses from intercompany transactions are disregarded (the same way transactions between a husband and wife filing a joint return in the personal income tax are disregarded). Thus, for example, dividends paid from one affiliated corporation to another are not counted as income since this is an intercompany transaction.

The portion of this total nationwide or worldwide net income that is taxable by California is then determined by formula, as described below.

4. APPORTIONMENT FORMULA

The formula is based on three "factors" -- payroll, property and sales. These three factors represent easily measurable basic corporate activities that contribute to profitability.

California generally uses the "double-weighted" sales factor apportionment method for most industries. That is, the formula uses a single payroll and property factor while including the sales factor twice (see example in Table 6). However, for certain industries (including agricultural, extractive savings and loan, and banking or financial institutions) the sales factor is single weighted and the formula is based on the simple average of the three factors.

The formula works as follows for each tax year:

- The corporation computes the ratio of its payroll in California (stated in dollars of value) to its payroll everywhere. It computes similar ratios for its California property and sales to property and sales everywhere. Note: The payroll and sales factors compare annual expenditures while the property factor uses an average of property owned and rented by the corporation at the beginning of the year and at the end of the year.

- The arithmetic average of the three ratios is computed using a denominator of three for agricultural, extractive, savings and loan, and banking or financial institutions, while double-weighting the sales factor and using a denominator of four for all other industries. This average represents the proportion of the corporation's total activity that it conducts in California.

- The average ratio computed above is applied to combined total net income to determine the share of the income of the unitary business that is apportioned to California.

- The corporate tax rate of 8.84% is applied to the net income apportioned to California.

The rules for apportioning income are modified for specific industries (including, for example, airlines, professional sports teams, construction contractors, franchisors, motion picture and television film producers, and trucking companies). In the case of certain forms of businesses, the rules for apportioning income are also modified for partnerships and personal service corporations. The modifications, established by Regulations issued by the FTB, typically provide special rules for computing the factors used in the apportionment formula. FTB Regulation 25137 sets forth circumstances that allow a departure from the standard formula. Table 6 shows the application of the apportionment formula for a hypothetical corporation.

Because formula apportionment is intended to tax only that portion of total income that is apportioned to California, double taxation of the same income by different jurisdictions normally does not occur. Therefore, no tax credit for taxes paid to other states is provided in the corporation tax law.

New Changes to Apportionment and Sales Factor Rules after January 1, 2013

Under current law, starting with the 2011 taxable year, qualified apportioning trades or businesses may make an annual, irrevocable election to utilize a single factor, 100% sales, (single sales factor) apportionment formula instead of the three factor, double-weighted sales apportionment formula. The election must be made on a timely filed original return in the manner and form prescribed by the FTB.

For taxable years beginning on or after January 1, 2013, Proposition 39 mandates the use of single sales factor apportionment by most multistate apportioning businesses. The option of using a three-factor, double-weighted sales apportionment formula is eliminated. Businesses specifically prohibited from electing a single sales factor apportionment formula are those that derive more than 50% of their gross business receipts from certain qualifying business activities, (specifically, agriculture, extractive business, savings and loans, and banking or financial institutions.)

Compact Election Issue

SB 1015 [(Committee on Budget and Fiscal Review), Chapter 37, Statutes of 2012], as enacted on June 27, 2012, repealed the state's Multistate Tax compact provisions and provided that the three-factor apportionment formula was not an option for California purposes, except for businesses that derive more than 50% of their gross receipts from certain qualifying business activities.

Definition of Doing Business

A bright-line test was established to provide that a taxpayer is doing business in California if any of the following conditions are satisfied:

A. The taxpayer is organized or commercially domiciled in this state.

B. Sales of the taxpayer in this state exceed the lesser of $500,000 or 25% of the taxpayer's total sales. Sales of the taxpayer include sales by an agent or independent contractor of the taxpayer.

C. The real and tangible personal property of the taxpayer in this state exceed the lesser of $50,000 or 25% of the taxpayer's total real and tangible personal property.

D. The amount paid in this state by the taxpayer for compensation exceeds the lesser of $50,000 or 25% of the total compensation paid by the taxpayer.

The amounts described in items B, C, and D above shall be updated by the FTB on an annual basis in a similar manner used to recompute the state income tax brackets.

Definition of Gross Receipts

Gross receipts are defined as the gross amounts realized (the sum of money and the fair market value of other property or services received), but do not include the following items:

- Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument.
- The principal amount received under a repurchase agreement or other transaction properly characterized as a loan.
- Proceeds from issuance of the taxpayer's own stock or from sale of treasury stock.
- Damages and other amounts received as the result of litigation.
- Property acquired by an agent on behalf of another.
- Tax refunds and other tax benefit recoveries.
- Pension reversions.
- Contributions to capital (except for sales of securities by securities dealers).
- Income from discharge of indebtedness.
- Amounts realized from exchanges of inventory that are not recognized under the Internal Revenue Code.

- Amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange or other disposition of those intangible assets.

- Amounts received from hedging transactions involving intangible assets.

Determination of Sales In California For Tangible Personal Property

The following rules for assigning sales from tangible personal property to the sales factor were added to the Corporation Tax Law:

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) or any member of the combined reporting group is taxable in this state.

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser out of state, and the taxpayer (seller) or any member of the combined reporting group is not taxable in the state of destination.

Determination of Sales in California for Other than Tangible Personal Property

The following rules for assigning sales of other than tangible personal property were added to the Corporation Tax Law:

- Sales from services are in this state to the extent the purchaser of the service received the benefit of the service in this state.

- Sales from intangible property are in this state to the extent the property is used in this state. In the case of marketable securities, sales are in this state if the customer is in this state.

- Sales from the sale, lease, rental or licensing of real property are in this state if the real property is located in this state.

- Sales from the rental, lease or licensing of tangible personal property are in this state if the property is located in this state.

For taxable years beginning before January 1, 2013, taxpayers electing to use the single sales factor apportionment formula, and for taxable years beginning on or after January 1, 2013, taxpayers required to use a single sales factor apportionment formula will use market-based sourcing of sales of services or intangibles. California's market-based sourcing rules generally sources sales of services to California if the taxpayer's customer receives a benefit of the service in the state. Receipts from intangibles are generally sourced to the state to the extent the property is used or located in the state.

TABLE 6

EXAMPLE: USE OF UNITARY APPORTIONMENT FORMULA FOR A HYPOTHETICAL CORPORATION

1) **Compute ratio of corporate assets in California to assets worldwide:**

	In California	Total Everywhere	Ratio of California to Total
Sales	$1,000,000	$20,000,000	5%
Property	4,000,000	40,000,000	10%
Payroll	2,000,000	10,000,000	20%

2) **Determine the apportionment factor:**

Agricultural, extractive, savings and loan, and banking or financial institutions: 5% + 10% + 20% = 35% divided by 3 = 11.6667%.

All other business activities: 5% + 5% + 10% + 20% = 40% divided by 4 = 10%.

Elective or Mandatory Single Sales Factor (Taxable Years Beginning on or after January 1, 2011) is 5%.

3) **Apply apportionment factor to total corporate net income to determine income apportioned to California:**

	Qualified Business Activities*	Business Activities	Elective or Mandatory Single Sales Factor
Worldwide Net Income of Corporation: *Multiplied* by Apportionment Factor	$5,000,000 x 11.6667%	$5,000,000 x 10%	$5,000,000 x 5%
Net Income Apportioned to California:	$ 583,335	$ 500,000	$ 250,000

4) **Apply California tax rate to determine tax:**

Income Apportioned to California: *times* Corporation Tax Rate:	$ 583,335 x 8.84%	$ 500,000 x 8.84%	$ 500,000 x 8.84%
Tax Due to California:	$ 51,567	$ 44,200	$ 22,100

*Agricultural, Extractive, Savings and Loan, and Banking or Financial Institutions.

5. WORLDWIDE COMBINATION

Initially, all worldwide unitary corporations were required to combine their worldwide operations and use the unitary method, as described above, computing worldwide factors and worldwide income. The apportionment percentage was expressed as California payroll, property, and sales as a percent of worldwide payroll, property and sales.

Numerous court challenges arose regarding California's ability to require worldwide combinations of the unitary businesses of multistate corporations. In a variety of cases, the United States Supreme Court confirmed the constitutionality of California's apportionment of income on a worldwide basis.

While judicial challenges advanced, taxpayers continued their arguments against worldwide combination and encouraged the Legislature to repeal the laws requiring combination. Arguments made to the Legislature for repealing mandatory worldwide combined reports for multinational corporations included the following:

- Property, payroll, and sales do not produce equal profits in all parts of the world. For example, labor may be cheaper (and thus relatively more profitable) overseas than in the United States. Thus, the formula is distorting and results in instances of double taxation by California and foreign nations.
- Fluctuations in international exchange rates make it difficult to put economic activities around the world on a consistent and comparable basis for purposes of the formula apportionment.
- The worldwide combination and apportionment system places excessive record keeping burdens on corporations.
- The worldwide system discourages corporations from making relatively less profitable investments in California because investment in California property will increase the share of the corporation's income subject to California tax. For example, start-up of a plant is often initially less profitable.
- This system discourages investment in California by foreign firms, thereby depriving the state of the potential employment growth associated with such investment.
- Foreign governments have protested that the system is unfair to their countries' businesses that operate worldwide and have threatened retaliation on U.S. corporations operating in their countries.

- Third world countries might copy the system of worldwide combination, potentially increasing tax burdens of businesses from industrialized nations.

In 1986, legislation was enacted to respond to these concerns. Under the new system, multinational corporations were allowed to elect one of two methods of determining income subject to tax in California, either worldwide combination or water's-edge combination.

6. WATER'S-EDGE COMBINATION

Multinational affiliated corporations that operate a unitary business may elect to combine only the affiliates that are designated as being within the "water's-edge." Affiliates outside the water's-edge are disregarded, and their income plays no direct role in the computation of income subject to tax in California. The concepts of unity and combination and the operation of the formula, as described above, continue to apply. In 2010, 7,564 corporations made the water's-edge election.

The major provisions applying to corporations that elect water's-edge combination are as follows:

Definition of "Water's-Edge". The "water's-edge" includes the 50 states of the United States and specified income activity of affiliates organized overseas. Thus, affiliates organized in the United States are considered <u>inside</u> the water's-edge and are combined. Affiliates organized overseas are considered <u>outside</u> the water's-edge and are not combined, except to the extent of their United States activities. However, affiliates organized overseas which have 20% or more of their activities in the United States are inside the water's-edge. In addition, state law requires a controlled foreign corporation (CFC) with Subpart F income to include a portion of its net income and apportionment factors in the water's-edge group tax filing based on an inclusion ratio.

So-called "80-20" corporations (United States-domiciled corporations with less than 20% of their activities in the United States) are also included within the water's-edge.

Water's-Edge Election Period. Prior to January 1, 2003, corporations that elected to use the water's-edge combination method made a contract with FTB for an initial term of 84 months. On the anniversary date of the contract, the election is automatically renewed on an annual basis unless a taxpayer provides FTB with a notice of nonrenewal. For taxable years beginning on or after January 1, 2003, the contract has been replaced with a statutory election that remains in effect until terminated.

Dividend Exclusion. Corporations electing water's-edge combination may exclude from income a portion of the dividends they receive from certain affiliates. The excludable amount is equal to 75% of all qualifying dividends received. However, dividends resulting from specified construction projects are 100% deductible.

In addition, California law provides that the water's edge group must assign the interest expense that relates to the excluded dividends to those dividends, and a proportionate amount of interest expense attributable to foreign investments can be offset against the deductible dividends.

Audits. The FTB may conduct audits of corporations electing water's edge combination to ensure that income is properly accounted for, especially between members of the water's-edge group and affiliates outside of the water's-edge group, and to prevent tax avoidance.

7. BUSINESS VERSUS NONBUSINESS INCOME

Business and nonbusiness income of multistate and multinational corporations is treated differently when determining California tax liability.

Business income is all income that arises from the conduct of trade or business operations. Most corporate income is business income and is apportioned to California or elsewhere by formula, as described above.

Nonbusiness income is that which does not arise in the normal course of the taxpayer's business operations. It can include such things as dividends from other corporations, interest, royalties, gains from the sale of investment properties, and the like so long as they are not related to the normal business of the corporation. In general, nonbusiness income is allocated in full to the state where the taxpayer is commercially domiciled in the case of income from intangibles, or where the relevant property is located in the case of income from tangible personal or real property.

8. FEDERAL TREATMENT OF MULTINATIONAL CORPORATIONS

Federal law taxes corporations in a manner similar to California taxation of individuals. Corporations organized in the United States (residents) are taxed on all of their income and are allowed a credit for taxes assessed by foreign countries because they have income sources there. Corporations organized outside the United States (nonresidents) are taxed on only their United States source income.

In making determinations of income source, the federal government uses the "separate accounting method". This method requires accounting separately for income streams and expenses attributable to each member of an affiliated group of corporations and to United States versus foreign operations. Transactions between affiliates are to be accounted for on an "arm's length" basis. That is, pricing is to be adjusted to reflect what the transactions would be if they were conducted at arm's length between competitor corporations rather than between affiliated corporations.

A key feature of the federal system is an aggressive audit program to ensure that arm's length pricing is used by affiliated corporations to accurately reflect the income and goods exchanged between related businesses. These are often referred to as "Section 482 audits". Due to the complexity and controversy associated with Section 482 audits, the Internal Revenue Service (IRS) initiated an Advance Pricing Agreement (APA) program. Under this program, taxpayers and the IRS agree upon the transfer pricing methods that should be applied before the tax return is filed.

9. CODE

Revenue and Taxation Code Sections 25101-25141

CHAPTER 2D
DETERMINING THE INCOME OF MULTISTATE AND MULTINATIONAL CORPORATIONS

CHAPTER 2E

SALES AND USE TAX

HIGHLIGHTS

• Tax Base	Total retail price of any tangible personal property unless the property is otherwise exempted; also imposed on certain state excise taxes, including those imposed on alcoholic beverages, and tobacco products.	
• Tax Rate	Total state and local base rate of 7.5%. Generally, the rate may be 7.625% to 10% in those cities and counties that impose additional rates.	
• Revenue*	2012-13	\$20.4 billion (General Fund)* \$ 2.9 billion (Local Revenue Fund) \$ 2.9 billion (Local Public Safety Fund) 21.3% of General Fund revenues
	2013-14 (Estimate)	\$23.0 billion (General Fund)* \$ 3.0 billion (Local Revenue Fund) \$ 3.0 billion (Local Public Safety Fund)
	2014-15 (Estimate)	\$24.0 billion (General Fund)* \$ 3.2 billion (Local Revenue Fund) \$ 3.2 billion (Local Public Safety Fund)

*Source: Governor's Budget Summary of 2014-15
BOE

1. OVERVIEW OF THE SALES TAX

The **sales tax** is imposed on retailers for the privilege of selling tangible personal property in California. Note, retailers are authorized to, and generally do, add sales tax to the sales price and collect reimbursement of the tax from the purchaser. The **use tax**, in contrast, is generally imposed on the use in California of tangible personal property purchased out of state.

Both the sales tax and the use tax are imposed on nearly identical items of tangible personal property. Tangible personal property is any physical asset, such as household goods and business equipment, which is readily movable and not permanently attached to real property. All sales of tangible personal property are taxable, unless specifically exempted by law.

However, sales of real property, such as land and buildings, are *not* subject to the sales tax. Furthermore, because the sales tax is imposed on *retail* sales, sales for resale and wholesale sales are excluded from the tax.

The measure of both the sales and the use tax are imposed on the retail price of the taxable personal property. The retail price is referred to as the "gross receipts" for sales tax purposes and the "sales price" for use tax purposes. Generally, no part of the retail price may be excluded from the tax base. If there is a manufacturers' or importers' excise tax, such as excise taxes imposed on tires, alcoholic beverages, and tobacco, it is included as part of the sales and use tax base. Generally, both state and federal excise taxes are included in the sales and use tax base. For example, an individual who purchases alcohol in the State of California must pay sales tax on the retail price of the alcohol, including the state and federal excise taxes.

Services are generally not subject to sales or use tax. However, when services contribute to the production or delivery of tangible personal property sold at retail, tax *does* apply to the entire sale price, with no deduction for the service component. This tax treatment follows the reasoning that acquisition of the tangible personal property is the true object of the transaction, and the service performed is deemed incidental. For example, in the sale of a custom-designed suit, the buyer's purpose is obtaining the clothing, which is tangible personal property. Although the tailor who designs and sews the suit performs a service of labor, the true object of the transaction is the sale of the suit, not the design and sewing services. Therefore, sales (or use) tax applies to the total price of the custom-tailored suit, including the design and tailoring.

Generally, leases of tangible personal property are considered "continuing" sales or uses and are subject to sales or use tax. Each payment made under the lease is subject to sales or use tax for the entire period that the leased property is located in California. Note: If a lease of tangible personal property covers property substantially in the same form as when acquired by the lessor and the lessor paid sales or use tax on the property when acquired, the rental payments are not subject to tax.

A seller's permit is a permit, furnished without charge by the State Board of Equalization (BOE), to sell tangible personal property in California. Generally, all persons or businesses that make retail or wholesale sales are required to hold a seller's permit.

In California, the retailer is liable for paying the sales tax. A retailer is described as anyone who makes more than two retail sales of tangible personal property within a 12-month period. As mentioned above, the retailer has the option of collecting a reimbursement of the tax from the consumer. However, if the retailer does not collect the sales tax reimbursement at the time of purchase, the retailer is still responsible for remitting the tax to the state.

The use tax is imposed on users of tangible personal property purchased out-of-state and brought into or delivered to California for use inside California. For example, an individual who purchases an automobile in the State of Washington and registers it in California is required to pay California use tax on his or her purchase; he or she is not subject to any Washington sales tax. Like the sales tax, the measure of the use tax is the sales price of the tangible personal property. The purpose of the use tax is to prevent persons from avoiding the California sales tax by purchasing at retail in states where the sales tax is lower than California or where there is no sales tax.

Unlike the sales tax, which is imposed on retailers, the use tax is imposed on California purchasers. However, out-of-state retailers that have substantial presence in California are required to register with the BOE and collect the use tax on taxable sales made to California consumers, whether the sale was made over the Internet, mail order, or telephone. Also, certain larger California businesses that do not sell goods in California are required to register with the BOE and track and report their use tax liabilities on their out-of-state taxable purchases. However, individual consumers and many small firms making purchases from unregistered out-of-state retailers are not required to register with the BOE and frequently do not report their use tax liabilities. Consequently, a significant portion of California use tax goes uncollected.

2. TAX RATES

Currently, the base state and local sales and use tax rate in California is 7.50%. This 7.50% rate is a combination of five different tax rates, as follows:

Imposed Statewide (Total = 7.50%)

NAME	RATE (%)	2012-13 REVENUE ($ BILLIONS)	USE OF REVENUE	BASIS OF ALLOCATION
"State" rate	3.9375	$20.4	State General Fund purposes	Not applicable
	0.25	$ 1.4	Fiscal Recovery Fund	
	0.25	$ 0.7	Education Protection Account	
	1.0625	$ 5.5	Local Revenue Fund 2011	
Local Revenue Fund rate	0.5	$ 2.9	Health and welfare programs shifted to local governments as part of 1991-92 state-local realignment	Allocated to counties based on population, percentage of persons below the poverty line, and changes in spending on health and welfare programs during prior years.

Imposed Statewide (Total = 7.50%)

NAME	RATE (%)	2012-13 REVENUE ($ BILLIONS)	USE OF REVENUE	BASIS OF ALLOCATION
Local Public Safety Fund rate	0.5	$ 2.9	Local public safety	Allocated primarily to counties based on sales during the prior year; cities receive about 6% of Local Public Safety Fund revenues based on amounts they lost as a result of the property tax shifts of the early to mid-1990s.
County Transportation rate	0.25	$ 1.5	County transportation purposes	Allocated to counties based on the location of sale
Bradley-Burns rate	0.75	$ 4.4	Local (city/county) general purpose use	Allocated to cities and counties based on the location of sale (to cities if the sale occurs in the city, to counties if the sale occurs in an unincorporated area of the county)

Also, each year a certain amount of the state sales tax revenues attributable to sales of diesel fuel must be transferred to the Public Transportation Account (PTA) within the State Transportation Fund. The amount transferred is determined by formula.

Additional Local Rates. The Transactions and Use Tax Law authorizes cities, counties, citywide and countywide authorities, and citywide and countywide special districts to impose additional sales and use taxes (officially 'transactions and use taxes'), subject to a vote of the people. In general, the Transactions and Use Tax Law authorizes taxes to be imposed in 0.125% increments, up to a total of 2%. (However, the Los Angeles Metropolitan Transportation Commission, the County of Alameda, and the County of Contra Costa may, upon voter approval, impose a 0.50% tax, even if it exceeds the 2% limitation).

As noted above, all transactions and use taxes are subject to voter approval. Pursuant to Proposition 218, passed by the voters in November 1996, general-purpose transactions and use taxes require majority voter approval; special-purpose transactions and use taxes require two-thirds voter approval.

As of January 1, 2014, 28 California counties, 117 cities and 1 town impose the sales tax at rates higher than 7.50% due to voter approval of imposition of additional taxes. In 2010-11 and 2011-12, these add-on taxes raised $4.2 billion and $4.6 billion, respectively, for the local governments that imposed them. See Table 7 in this chapter for the list of cities and counties with additional rates.

TABLE 7

Existing Transactions and Use Taxes (As of 01/01/14)

Jurisdiction	Rate	Purpose
Alameda County	1.5%	Transit / Hospital
Amador County	0.5%	Fire / Emergency Medical
City of Arcata	0.75%	General Fund
City of Arroyo Grande	0.5%	General Fund
City of Arvin	1.0%	General Fund
City of Avalon	0.5%	Hospital and Clinic
City of Calexico	0.5%	General Fund
City of Campbell	0.25%	Vital City Services
City of Capitola	0.5%	General Fund
City of Cathedral City	1.0%	General Fund
City of Ceres	0.5%	Public Safety
City of Clearlake	0.5%	Public Safety
City of Concord	0.5%	General Fund
City of Cotati	0.5%	General Fund
City of Davis	0.5%	General Fund
City of Delano	1.0%	General Fund
City of Del Rey Oaks	1.0%	General Fund
City of Dinuba	0.75%	Police / Fire
City of El Cajon	1.0%	Public Safety / Services
City of El Cerrito	1.0%	Street Improvement / General Fund
City of El Monte	0.5%	General Fund
City of Eureka	0.75%	General Fund
City of Farmersville	0.5%	General Fund
City of Fort Bragg	1.0%	Road Maintenance/CV Starr Center
City of Galt	0.5%	Public Safety
City of Grover Beach	0.5%	General Fund
City of Gustine	0.5%	Community Services
City of Hollister	1.0%	General Fund
City of Inglewood	0.5%	General Fund
City of La Habra	0.5%	General Fund
City of La Mesa	0.75%	General Fund
City of Lakeport	0.5%	General Fund
City of Los Banos	0.5%	Public Safety
City of Mammoth Lakes	0.5%	Parks and Recreation
City of Manteca	0.5%	Public Safety
City of Marina	1.0%	General Fund
City of Merced	0.5%	General Fund
City of Montclair	0.25%	General Fund

TABLE 7

Existing Transactions and Use Taxes (As of 01/01/14)

Jurisdiction	Rate	Purpose
City of Morro Bay	0.5%	General Fund
City of Mount Shasta	0.25%	Libraries
City of National City	1.0%	General Fund /
City of Nevada	0.875%	Street Improvement / General Fund
City of Novato	0.5%	General Fund
City of Oxnard	0.5%	Vital Services
City of Pacific Grove	1.0%	General Fund
City of Pico Rivera	1.0%	General Fund
City of Pinole	0.5%	General Fund
City of Pismo Beach	0.5%	General Fund
City of Placerville	0.5%	Public Safety / General Fund
City of Point Arena	0.5%	General Fund
City of Port Hueneme	0.5%	General Fund
City of Porterville	0.5%	Public Safety / Police / Fire
City of Reedley	0.5%	Public Safety
City of Richmond	0.5%	General Fund
City of Rohnert Park	0.5%	General Fund
City of Salinas	0.5%	General Fund
City of San Bernardino	0.25%	General Fund
City of Sand City	0.5%	General Fund
City of Sanger	0.75%	Public Safety
City of San Juan Bautista	0.75%	General Fund
City of San Leandro	0.25%	General Fund
City of San Luis Obispo	0.5%	Essential Services
City of San Mateo	0.25%	General Fund
City of San Rafael	0.5%	General Fund
City of Santa Cruz	0.5%	General Fund
City of Santa Monica	0.5%	General Fund
City of Santa Rosa	0.5%	Public Safety / General Fund
City of Sebastopol	0.75%	General Fund
City of Seaside	1.0%	General Fund
City of Selma	0.5%	Public Safety
City of Sonora	0.5%	General Fund
City of South El Monte	0.5%	City Services Protection
City of South Gate	1.0%	General Fund
City of South Lake Tahoe	0.5%	General Fund
City of Stockton	0.25%	Public Safety

TABLE 7

Existing Transactions and Use Taxes (As of 01/01/14)

Jurisdiction	Rate	Purpose
City of Tracy	0.5%	General Fund
City of Trinidad	0.75%	General Fund
City of Tulare	0.5%	General Fund
City of Ukiah	0.5%	General Fund
City of Union City	0.5%	General Fund
City of Visalia	0.25%	Public Safety
City of Vista	0.5%	General Fund
City of Watsonville	0.25%	General Fund
City of West Sacramento	0.5%	General Fund
City of Wheatland	0.5%	General Fund
City of Williams	0.5%	General Fund
City of Willits	0.5%	Road System
City of Woodland	0.75%	General Fund
Contra Costa County	1.0%	Transit
Fresno County	0.725%	Transit / Libraries / Zoo
Imperial County	0.5%	Transit
Inyo County	0.5%	General Fund
Los Angeles County	1.5%	Transit
Madera County	0.5%	Transit
Marin County	1.0%	Transit / Rail / Open Space
Mariposa County	0.5%	County Healthcare
Napa County	0.5%	Flood Protection
Nevada County	0.125%	Public Libraries
Orange County	0.5%	Transit
Riverside County	0.5%	Transit
Sacramento County	0.5%	Transit
San Bernardino County	0.5%	Transit
San Diego County	0.5%	Transit
San Francisco City and County	1.25%	Transit / Public Finance
San Joaquin County	0.5%	Transit
San Mateo County	1.5%	Transit / General Fund
Santa Barbara County	0.5%	Transit
Santa Clara County	1.25%	Transit / General Fund
Santa Cruz County	0.75%	Transit / Public Libraries
Solano County	0.125%	Public Libraries
Sonoma County	0.75%	Agricultural Preservation / Open Space / Transit/Rail

TABLE 7

Existing Transactions and Use Taxes (As of 01/01/14)

Jurisdiction	Rate	Purpose
Stanislaus County	0.125%	Public Libraries
Town of Truckee	0.5%	Road Maintenance
Tulare County	0.5%	Transit

3. EXEMPTIONS

All retail sales of tangible personal property are taxable in California unless the property is specifically exempted. Some major exemption categories are described below.

Necessities. The following items are granted general sales and use tax exemptions:

- Food (other than hot prepared food) for human consumption;
- Prescription medicines, wheelchairs, crutches, canes, walkers, medical oxygen delivery systems, hemodialysis products, and prosthetic devices;
- Gas, electricity, and water delivered through mains, lines, or pipes;
- Food for animals normally raised for human consumption; and,
- Fertilizer and seeds applied to land used to grow foods for human consumption.

Interstate Commerce. The Commerce Clause of the U.S. Constitution prohibits states from imposing taxes that place an undue burden on people or businesses engaged in interstate commerce. To comply with the U.S. Constitution, California has enacted laws that exempt sales of certain property involved in interstate commerce.

For example, interstate sales of vessels and aircraft, aircraft fuel used during international flights and hot prepared food sold to air carriers for passenger consumption are exempt from the sales tax.

California has also enacted laws that complement the U.S. Commerce Clause and that level the playing field for businesses that engage in interstate commerce activities in the state. For example:

- In-state sellers are allowed to deliver property for out-of-state use to common carriers in California without any sales tax being imposed.

- Businesses are not taxed on the printed sales messages they commission and have mailed to potential customers.
- Air common carriers are not taxed on the fuel used on international flights.

Without these additional laws, California businesses could be at a disadvantage vis-à-vis competitors based in other states.

Exemptions for Nonprofit and Government Organizations. Pursuant to the U.S. Constitution, all sales of tangible personal property to the federal government are exempt from tax. Museums are also exempted from sales tax on works of art they purchase for public display.

Several nonprofit organizations are allowed a partial sales tax exemption for certain items they sell under specified circumstances. The exemption is considered partial because the tax is computed based on the wholesale price of the organization's products, which presumably is lower than the retail price. For example, when the Girl Scouts make handicrafts they later resell, they remit sales tax based on the wholesale price of the materials used to make the handicrafts. Unlike most retailers, they do not have to collect or remit the sales tax based on the price for which the handicrafts are subsequently sold. Generally, the partial sales tax exemption is limited to sales of food, non-alcoholic beverages, and handcrafted items.

Groups currently eligible for partial sales tax exemptions include: Little League; Bobby Sox; Boy Scouts; Cub Scouts; Girl Scouts; Campfire Girls; YMCA; YWCA; Future Farmers of America; Future Homemakers of America; 4-H Clubs; American Youth Soccer Organization; California Youth Soccer Associations; Pop Warner Football; Special Olympics; and school-sponsored youth groups, such as high school teams. Organizations that provide vocational training services to the developmentally disabled or services to children with severe emotional disturbances are also allowed a partial exemption on the sale of handicrafts that are made by their clients and retail for $20 or less.

Other Exemptions. A few of the other major items exempted from all or a portion of the sales tax include: equipment used in manufacturing, biotechnology, and physical, engineering and life science research; farm equipment; timber-harvesting equipment; racehorse breeding stock; motion picture production services; motion picture leases; returnable containers; custom computer programs; subscription periodicals; master records and tapes; property that will be used in space flights; and bulk sales of monetized and nonmonetized bullion. For a complete list of exemptions see the BOE publication titled *Sales and Use Taxes: Exemptions and Exclusions*. For additional information on these exemptions, contact the BOE.

4. SALES IN CALIFORNIA BY OUT-OF-STATE RETAILERS

California's ability to collect use tax resulting from internet, mail order and catalogue sales is significantly limited for the following two reasons: (a) U.S. Supreme Court decisions in *National Bellas Hess v. Illinois Department of Revenue* (1967) and *Quill Corporation v. North Dakota* (1992), which prohibit states from requiring mail order houses to collect and remit use taxes; and (b) the fact that consumers are legally liable for the use tax on these mail order sales. At present, however, California fails to collect approximately $1.1 billion in revenues as a result of unreported use taxes.

The *Quill* and *National Bellas Hess* Cases. Two U.S. Supreme Court decisions prohibit states from requiring mail order sellers to collect state use taxes unless the seller has physical nexus in the state. In the *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois* (1967) case, the U.S. Supreme Court held that when a business does no more than communicate with customers by mail or common carrier as part of a general interstate business, requiring that business to collect and pay the use tax violates the U.S. Constitution. In *Quill Corporation v. State of North Dakota* (1992), the Supreme Court interpreted the Commerce Clause of the U.S. Constitution as prohibiting states from imposing use tax collection obligations on retailers whose only connection with customers in the taxing state is through mail order sales.

Both decisions leave the door open for Congress to establish a framework for uniform state taxation that does not impede interstate commerce. In an effort to simplify various states' sales and use tax systems, forty-four states, including California, and the District of Columbia, that levy a sales and use tax participated in the Streamlined Sales Tax Project (SSTP), and on October 1, 2005, the "Streamlined Sales and Use Tax Agreement" became effective. This Agreement creates a blueprint for a simplified tax collection system and attempts to alleviate the burden and cost of tax collection for sellers. The agreement addresses issues associated with tax collections, definitions of the tax base, uniformity of tax bases, electronic registration of sellers, simplification of tax rates, simplification of returns and remittances, uniform sourcing rules, as well as other issues. The Project is conducting its work through a steering committee with co-chairs, four work groups, and a number of sub-groups. Project participants are generally state revenue department administrators but there are also representatives of state legislatures and local governments. Businesses including national retailers, trade associations, manufacturers, direct marketers, telecommunications companies, leasing companies, technology companies, printers, accounting firms, and others are actively participated in the Project by offering expertise and input, reviewing proposals, suggesting language, and testifying at public hearings. Twenty-two states have been certified to be in substantial compliance with the Agreement, which means they have changed their laws so that they meet all the requirements of the Agreement.

Participation in the Project does not change any law or tax reporting/collection responsibilities of remote sellers. However, California legislators could choose to amend California's Sales and Use Tax Law to conform to the provisions of the Agreement if such conformity is desired.

Nexus and Use Tax Collection. California law requires every retailer "engaged in business in this state" to collect sales or use tax from the consumer at the time of sale. The definition of a "retailer engaged in business in the state" includes, among others, any retailer who:

- Maintains, occupies, or uses an office, place of distribution, sales or sample room, warehouse or other storage space, or other place of business in California;

- Has an affiliate operating in California that refers potential customers to the retailer, by an internet-based link, Internet website, or otherwise, under specified circumstances;

- Is a member of a commonly-controlled group and combined reporting group and has a member of the retailer's combined reporting group and commonly-controlled group performing services for the retailer in California that help the retailer establish or maintain a California market for sales of tangible personal property.

Out-of-state retailers who are deemed to be "engaged in business in this state" are required to collect and remit use tax to BOE. Some other out-of-state sellers also voluntarily collect and remit use taxes to BOE, usually when there is some question about whether their business activities in California represent nexus.

Since 1998, certain taxpayers have been allowed to obtain a use tax direct payment permit from BOE. Use tax direct payment permits allow qualifying taxpayers to self-assess and pay state and local use tax directly to BOE, thereby removing sellers of the responsibility to do so. To be eligible, an applicant must purchase or lease at least $500,000 worth of tangible personal property during the calendar year immediately preceding the application or be a county, city, city and county, or redevelopment agency. Use tax direct payment permits provide local taxing jurisdictions with a mechanism to increase the amount of local use tax revenue they receive and provide large businesses with a mechanism to minimize their chances of being audited for an outstanding use tax liability.

Legislation enacted in 2003 authorized taxpayers to report their use tax liabilities on their California income tax returns. Any use tax liability reported on a timely filed income tax return is deemed to be timely filed and paid.

The use tax also applies to foreign purchases in excess of $800 that are brought into California. California assesses the use tax due on these purchases using information from U.S. Customs Service declarations completed by returning travelers at California ports of entry.

5. SPECIAL PROVISIONS OF THE SALES TAX

Occasional Sales. Occasional sales of property are generally not subject to the sales tax. A sale is deemed "occasional" when the seller is not required to hold a seller's permit and the sale is not one of a series of sufficient duration to require a seller's permit. For example, an individual holding a garage sale over the course of a weekend would not be required to hold a seller's permit or pay sales tax on the items sold.

Swap Meets and Flea Markets. Operators of a swap meet, flea market, or special event are required to obtain evidence that each seller who leases space from the operator of the swap meet is the holder of a valid seller's permit or is not selling any item that is taxable under the sales and use tax law.

Automobiles. When a licensed automobile dealer sells a new or used vehicle, the sales tax must be collected at the time of purchase. The sales tax rate is based on the jurisdiction in which the purchaser resides. For example, if the purchaser buys a car in a jurisdiction with a 7.50% sales tax rate but registers the car in a local community with a 7.75% rate, the dealer is responsible for collecting tax at the 7.75% rate and remitting it to BOE.

When a private non-dealer sells a car, he or she is not required to collect the sales tax. Instead, use tax is collected when the owner registers the automobile with the Department of Motor Vehicles. Here again, the purchaser is required to pay tax at the rate of the local community in which the car is registered, regardless of where the car is purchased.

Mobilehomes and Factory-Built Housing and Schools. A partial sales tax exemption is allowed to mobilehome dealers on sales of new mobilehomes that are sold to customers for occupancy as a residence. In these transactions, the mobilehome dealer is the "retailer-consumer" and is required to declare and pay tax on 75% of the dealer's purchase price of the mobilehome. No tax is imposed on the sale of such new mobilehomes to customers. Section 2 of Chapter 6G contains more information on application of the sales tax to mobilehomes.

A partial exemption is also allowed on the sales price of certain factory-built housing and schools. For factory-built homes, 60% of the retail sales price is exempt from the sales tax.

6. DEDUCTING THE SALES TAX

Individuals are not allowed a state personal income tax deduction for the sales and use tax they pay during the course of each year unless the tangible personal property was purchased for use in a trade or business.

Sales taxes are generally deductible for tangible personal property purchased for use in a trade or business. However, sales taxes incurred in the process of manufacturing or constructing property must be capitalized into the value of the property rather than deducted immediately.

7. REMITTANCE OF THE SALES TAX BY RETAILERS

Reimbursement of the Sales Tax. Retailers are legally liable for remitting sales tax to the state. However, retailers are permitted to collect a "reimbursement" of the sales tax from the consumer, which is normally itemized separately as sales tax when an item is sold. The law provides for statutory reimbursement tables to be used by retailers to compute the tax on any sales transaction.

The basic rule for computing the sales tax reimbursement, since taxpayers cannot pay fractions of cents, is to round fractions equal to or larger than ½ cent up to the next cent and round fractions of less than ½ cent down to the next lower cent.

Payments and Prepayments. In general, retailers must remit sales taxes to the state on a quarterly basis. However, retailers with taxable sales of over $17,000 per month are generally required to remit sales taxes on a monthly basis. Each quarter, two prepayments and one final payment are due, with payments generally required one month following the month in which liability is incurred. Prepayment schedules are intended to help ensure a steady flow of sales and use tax revenue to the state rather than four quarterly spikes of revenue during the course of each year.

The prepayment and final payment schedules for the first, third, and fourth calendar quarters of each year are identical. The second quarter prepayment schedule was changed in order to help the state's cash flow needs during tight budget years and operates to shift more revenue to the months of May and June (the last two months of the fiscal year).

Electronic Funds Transfer. Retailers with sales tax liabilities averaging $10,000 or more per month are required to remit their tax payments via an Electronic Funds Transfer (EFT). Retailers that are not required to make sales and use tax payments through EFT may voluntarily pay by EFT after contacting BOE and completing an authorization agreement form.

8. ADMINISTRATION

The sales and use tax is administered by the BOE. The BOE drafts regulations to clarify and interpret the sales and use tax laws and handles collections and appeals. The BOE also administers all local sales (and transactions) and use taxes under contract with local taxing agencies. These contracts allow BOE to charge local jurisdictions for its costs to administer the local taxes.

9. CODE

California Constitution, Article XIII, Section 29, Section 35, and Section 36

Revenue and Taxation Code Sections 6001 – 7292