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by Louis E. Michelson

Booster Shots

California's new tax law provides incentives to attract businesses across the country and around the world

AS CALIFORNIA STRUGGLES TO EMERGE from its economic recession, tax incentives for business continue to be a hot legislative topic in Sacramento. In many ways, it's a game of catch-up: California is trying to emulate other states that have been more successful in attracting business and jobs.

This became clear in a recent *Forbes* magazine article that handicapped the prospects of all 50 states for job growth in four areas: 1) the relative cost of doing business; 2) the impact of lower defense budgets; 3) possible job losses from the Clinton administration's health care proposals; and 4) expected benefits from new export markets.¹ California received an "excellent" rating only in the last area; the state's overall grade was "poor." Nevada, Arizona, Utah, and Idaho have gained jobs at California's expense.

Missing from the *Forbes* article, however, is mention of the recent enactment of several laws that provide inviting incentives for businesses to locate or expand in California. In October 1993, Governor Pete Wilson signed S.B. 671—legislation designed to attract and retain business in California.

However, S.B. 671 is only one important piece of the legislative puzzle. Many other bills have been enacted in a short span of time, so it is worthwhile to examine carefully the numerous incentive provisions which, if used properly, can save substantial taxes. These incentives affect the income taxes of individuals, the franchise/income taxes imposed on banks and corporations, sales and use taxes, and even property taxes.²

The "water's edge election" dispute. A portion of S.B. 671 had international implications and attracted considerable media and worldwide attention: the unitary tax legislation. That can be viewed as removing a disincentive for multinationals to do business in California.

California taxes multinational companies on a portion of their worldwide income. Since 1988 California has offered an alternative method, commonly known as the "water's edge," by which multinationals can elect to be taxed only on their operations within the water's edge of the United States.³ This means

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MCLE Test No. 21

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1. ABC, Inc., a professional law corporation (a C corporation), issues stock to a new shareholder, Dalia, in January 1995. All of ABC's employees are California residents, and 90 percent of the assets used in conducting ABC's business are located in California. If Dalia sells her stock in ABC, Inc. in February 2000:

A. Half of her gain is excludable for both federal and California income tax purposes.

B. Half of her gain is excludable for federal income tax purposes only.

C. Half of her gain is excludable for California income tax purposes only.

D. Her gain is not excludable either for federal or California income tax purposes.

2. The U.S. Supreme Court recently held in *Barclay's Bank PLC v. California Franchise Tax Board* that California's unitary tax method of taxing U.S.-based multinational corporations on their worldwide income was constitutional, but the method was unconstitutional as applied to foreign-based multinational corporations.

True.

False.

3. Under S.B. 671:

A. The water's edge election fee was eliminated.

B. The domestic disclosure spreadsheet requirement was repealed.

C. The Franchise Tax Board can no longer disregard the water's edge election.

D. All of the above.

HYPOTHETICAL 1

Widget Inc., in celebration of its 20th anniversary in business, purchases new widget-manufacturing equipment in February 1994, but places it into service in September 1994. Its upstart competitor, Littlewig Inc., which began business only in June 1994, purchases identical manufacturing equipment and places it into service in September 1994.

4. Widget Inc. can claim an investment tax credit of:

A. 0.5 percent of the purchase price for each month beginning in February 1994 to a maximum of 6 percent.

B. 0.5 percent of the purchase price for each month beginning in September 1994 to a maximum of 4 percent.

C. 6 percent of the purchase price of equipment placed in service in September 1994.

D. No credit can be claimed because the equipment was not placed in service by January 1994.

5. Widget Inc. can claim an investment tax credit on its corporate tax return for its 1994 purchases in addition to any qualified 1995 purchases.

True.

False.

6. Any investment tax credit not used by Widget Inc.:

- A. Can be carried forward for five years.
- B. Can be carried forward for seven years.
- C. Can be carried forward for nine years.
- D. Can be carried forward as long as

Widget Inc. retains the property.

7. Assuming that Littlewig Inc. is a qualified small business, any investment tax credit not used by Littlewig Inc.:

- A. Can be carried forward for five years.
- B. Can be carried forward for seven years.
- C. Can be carried forward for nine years.
- D. Can be carried as forward as long as

Littlewig Inc. stays in business.

8. Littlewig Inc. and Widget Inc. each can claim a sales tax exemption on its purchase of the manufacturing equipment instead of the investment tax credit.

- True.
- False.

9. If Widget Inc. moves its manufacturing equipment from California to Nevada in January 1995 in order to reduce operating costs, the credit or carryover remains available.

- True.
- False.

10. Under the provisions enacted by S.B. 671:

A. The requirements for the 6 percent investment tax credit and the sales tax exemption are identical.

B. Both the credit and sales tax exemption are expected to generate 100,000 new jobs or else an automatic sunset provision will be triggered.

- C. Both A and B are true.
- D. Both A and B are false.

11. The California corporate tax on S corporations was reduced to 1.5 percent under S.B. 671.

- True.
- False.

12. In S.B. 671 California conformed state law to federal law for:

- A. Credits for qualified research expenditures.
- B. Deductions for business meals.
- C. Net operating loss deductions.
- D. All of the above.
- E. Only A and B.

13. As a general rule, under the newly reinstated deduction, 50 percent of net operating losses can be carried forward for five years for California tax purposes.

- True.
- False.

HYPOTHETICAL 2

Hearts, Inc. was organized on February 14, 1994, and began business in March 1994. It is not the successor to any other trade or business conducted by its sole shareholder, either under the related party or attribution rules. Hearts, Inc. expects to have net operating losses for its first few years of business.

14. Hearts, Inc. appears to qualify for the use of the generous NOL provisions for new businesses.

- True.
- False.

15. Hearts, Inc. can carry forward the NOL from its first year of business for:

- A. Five years.
- B. Six years.
- C. Seven years.
- D. Eight years.

16. A maximum of 75 percent of Hearts, Inc.'s net operating losses can be carried forward, not just 50 percent.

- True.
- False.

17. Small businesses are able to carry forward 100 percent of their losses.

- True.
- False.

18. The three-factor apportionment formula is based on property, payroll, and sales both within and without California. This formula historically gave equal weight to all three factors but has been changed recently to place additional weight on the sales factor.

- True.
- False.

19. Investment income received by nonresident investors generated by California money managers:

A. May be exempt from tax if the dividends, interest, and gains or losses are from certain "qualifying investment securities."

B. Might become California "source" income if the nonresident traded systematically enough so as to constitute doing business in California, absent the new business incentive.

- C. Both A and B are true.
- D. Both A and B are false.

20. Localized tax incentives, such as hiring credits, accelerated write-offs of machinery and equipment, and sales and use tax credits were enacted to provide incentives for investment, employment, and development in selected designated areas in California.

- True.
- False.

the federal income tax law providing for a credit for qualified research expenditures, and the credit was due to sunset on January 1, 1998.³⁷ Recent reported statistics indicate that more than 3,100 California businesses took advantage of this credit.³⁸ The legislature therefore made the credit permanent and further conformed the computation of the credit to federal law, thereby increasing the amounts that could be claimed.³⁹

Space flight boost initiative. One very local incentive included in S.B. 671 exempts purchases of property used in space flights originating from Vandenberg Air Force Base, located in Lompoc,⁴⁰ from sales and use tax.⁴¹ This provision was introduced earlier by Assemblywoman Andrea Seatrand in A.B. 279, but it reappeared in S.B. 671. One of the intended beneficiaries is Huntington Beach-based McDonnell Douglas Commercial Delta, Inc., which is reported to have a tentative deal to launch 66 satellites in 1995 for futuristic mobile phone systems.⁴² McDonnell Douglas's key competitor for the launch contract was reported to be a French state-owned entity that operates tax-free. The initiative's intent was to put the California company on an equal footing.⁴³

Net operating losses. Two bills signed by Governor Wilson on October 6, 1993—S.B. 671 and A.B. 34—resurrected the NOL deduction,⁴⁴ which had been unavailable to California businesses for the 1991 and 1992 tax years when NOLs were suspended as part of a budget agreement.⁴⁵ When NOLs were enacted in 1987, California did not conform to federal tax law and only permitted carryover of 50 percent of the net operating loss of any taxable year (versus federal law, which allows 100 percent carryover) and did not permit net operating losses to be carried back against prior years (versus federal law, which permits carrybacks for three years).⁴⁶ In reinstating the deduction, the legislature retained these restrictions and further reformed it in several ways.

The new NOL provisions cut back on the number of years to which NOLs can be carried forward; as a general rule NOLs now can be carried forward only five years, not 15 years as in the federal NOL, although there are special California incentives. The basic policy rationale for allowing a NOL deduction, as set forth in an Assembly committee report for this legislation, is to allow businesses to "even out" their income across years and thus more accurately reflect the ability of a business to pay taxes.⁴⁷

The prior law 15-year carryover period was viewed as an abuse of an otherwise supportable policy. One of the justifications offered for the shortened carryover period was based on a FTB revenue analysis indicating that the usage of NOLs drops by almost 50 percent after five years—thus suggesting that five years roughly equals

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Booster Shots

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the business cycle.⁴⁸ The other rationale offered for the shortened period stems from the continued nonconformity of California law to federal law.⁴⁹ The state also offers more attractive provisions for new businesses and small companies.

NOLs for new businesses and small companies. New businesses that incur losses in their first three years of operations benefit two ways. First, 100 percent of their net operating losses, not just 50 percent, can be carried forward.⁵⁰ Further, new businesses can deduct their first-year losses for eight years and their second- and third-year losses for seven and six years, respectively.⁵¹ Any subsequent losses can be carried forward for five years.

A new business must meet three requirements to use these generous NOL provisions:

- 1) It must be organized or formed on or after January 1, 1994.
- 2) It must first commence business activity in 1994.⁵²
- 3) It may not include "any trade or business" that was used in any predecessor trade or business conducted by the taxpayer or any person or entity attributed to the taxpayer, using related party loss disallowance rules and constructive ownership attribution rules to define who is considered a related party.⁵³

The NOL provisions were revised to favor small businesses. Current usage of NOL deductions based on data compiled by the FTB indicates that approximately 74 percent of all companies claiming NOLs had annual receipts of less than \$1 million, although they accounted for only 16 percent of the total NOL deductions claimed. However, firms with gross receipts in excess of \$50 million account for only 1.2 percent of all firms but claim nearly half of all NOL deductions.⁵⁴ At the Assembly floor hearing, the new provisions were referred to as providing "additional tax relief" to new and small businesses.⁵⁵ As originally proposed by the Assembly Committee on Revenue and Taxation, small businesses would have been able to carry forward 75 percent (instead of 50 percent) of their losses.⁵⁶ However, the Senate increased the percentage from 75 percent to 100 percent, with the concurrence of the Assembly and Governor Wilson.⁵⁷

Another significant Senate amendment recognized that the California economy is still in a recession by adding a special provision for taxpayers emerging from a Title 11 bankruptcy or reorganization. For NOLs generated after 1986 and before 1994, a special 10-year carryforward period was provided. The extended loss carryover only applies to losses generated when the taxpayer is under the jurisdiction of the

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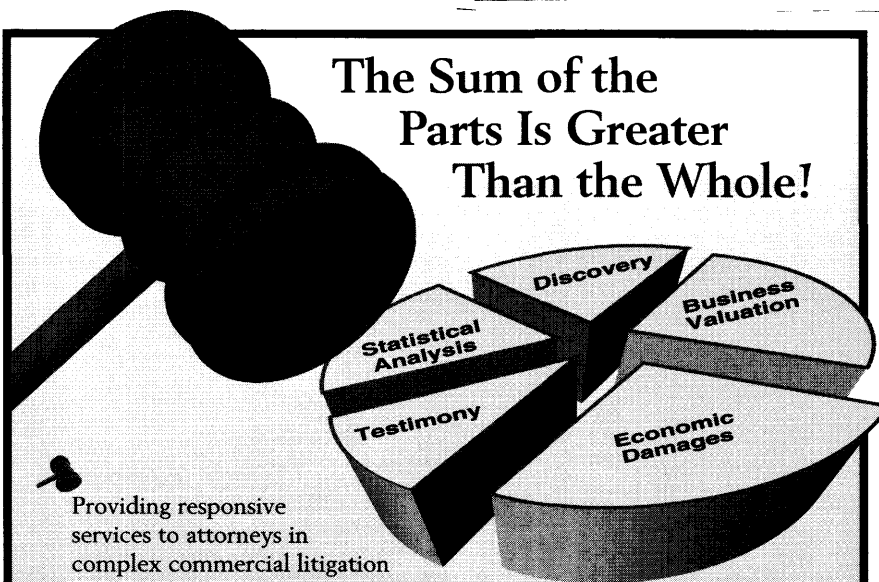


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court during that period.⁵⁸

Two technical points are worth noting. First, the two years (1991 and 1992) during which loss deductions were suspended do not count in the calculation of the carry-over periods.⁵⁹ Also, under the sunset provision of prior law, no carryovers would be permitted in 1997. While it was clear that the sunset provision was being repealed in A.B. 34, the subsequent passage (on the same day) of S.B. 671 reinstated the old sunset provision. The FTB has reportedly stated that this legislative reinstatement of the sunset provision was inadvertent.⁶⁰

Other business incentives. Two other October 1993 tax incentive bills signed by the governor should not be overlooked. The first bill, S.B. 1176 (Kopp), applies to the three-factor apportionment formula, and the second bill, S.B. 723 (Kopp), contains provisions on taxation of nonresident investors.

To understand the significance of S.B. 1176, recall that California taxes the business income of taxpayers that operate unitary businesses only on that portion of total income earned in California. The California portion is calculated using a formula based on property, payroll, and sales both within and without the state.⁶¹ This formula historically gave equal weight to all three factors.

However, in an effort to reduce taxes on in-state businesses and increase taxes on out-of-state businesses, as many as 25 other states in recent years have changed their apportionment formulas and placed additional weight on the sales factor relative to the property and payroll factors.⁶² California has now joined this movement, so that in the new apportionment formula the sales factor is double-weighted, although the old formula continues to apply to certain extractive or agricultural business activities.⁶³

Boosters of this legislation believe that this change will attract manufacturing and investment to California. Opponents of this legislation note that the revised formula may penalize companies that locate manufacturing facilities primarily in California to serve the California market. California taxes for these companies will increase under the new formula because California taxes will increase whenever the sales factor exceeds the average of the property and payroll factors, even if the latter factors are substantial.⁶⁴

Tinkering with the apportionment formula continues in the legislature as the new formula causes increased taxes due to the double-weighted sales factor. For example, legislation sponsored by the California League of Savings Institutions already is being considered to restore the old formula for the savings and loan industry.⁶⁵ California-based savings and loans institutions have been hit hard by the increased income apportioned to California primarily due to interest income on loan payments, which result in a larger sales factor.

The second bill, S.B. 723, contains numerous provisions, but the business incentive in the bill is directed at investment income generated by California money managers and received by nonresident investors. Generally, income from stocks and bonds and other investment intangibles is taxed at the owner's home state. However, one significant exception to this rule concerns a nonresident who places his money with a California investment money manager who in turn buys and sells intangibles regularly and systematically enough to constitute the nonresident's doing business in California through an agent. The investment income becomes California "source" income and is taxable.

The possibility of such investors moving their money to out-of-state advisors (or the advisors moving out of state) prompted concern about loss of jobs and revenue, which led to the passage of a special exemption for dividends, interest, and gains or losses from certain "qualifying investment securities."⁶⁶ Cries of "tax breaks for the wealthiest investors in the country" were even noted in one of the committee reports that preceded passage of S.B. 723.⁶⁷

Beyond the October 1993 legislation there are even more tax incentives that astute business executives can utilize, including localized tax incentives created in the Employment and Economic Incentive Act, the Enterprise Zone Act, and the Los Angeles Revitalization Zone legislation of 1992; and the Local Base Military Recovery Act of 1993.⁶⁸ These programs provide incentives for investment, employment, and development in selected designated areas variously called "program areas," "enterprise zones," the "Los Angeles Revitalization Zone," and "local military base recovery areas." The incentives include hiring credits, sales and use tax credits, tax exemptions of income from investments in certain areas, accelerated write-offs of machinery and equipment, income tax credits for sales and use tax paid on purchase of certain machinery, net operating loss carryovers—and the list goes on.⁶⁹

The bottom line. These incentives have not been introduced without cost and controversy. Critics have called the October 1993 tax legislation "a Christmas tree of goodies for business instead of sweeping tax reform."⁷⁰ Detractors notwithstanding, California is making a major investment in trying to attract businesses based on the fiscal effect of the act as announced in committee reports. Revenue losses from the capital gains exclusion alone, which do not begin until 1998-99, are estimated to be \$15 million, increasing to \$43 million by 2001-02. The 6 percent investment tax credit could result in losses ranging from \$50 to \$100 million in 1994-95, all the way to \$300 to \$350 million in 1996-97.⁷¹ Not surprisingly, one of the other items that should be reported back to the legislature includes the "estimated state and local fis-

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cal impact of the act."⁷²

Remarkably, the legislation signed in October 1993 was proudly touted by both sides of the political spectrum. Governor Wilson said that the "tax reforms are the centerpiece of an economic growth agenda" and declared it to be the "most sweeping tax reform since Proposition 13."⁷³ Assembly Speaker Willie Brown described the final legislation "as perhaps the most important bill of the session"; he referred to S.B. 671 as "extraordinarily significant."⁷⁴ Businesses, by their investments in people and capital in California, ultimately will determine whether this legislation serves its intended purpose and lives up to expectations. ♦

¹ R. Koselka, *The Fight for Jobs*, FORBES, Jan. 31, 1994, at 68.

² See, e.g., A.B. 1823 (Alpert), 1993 Cal. Stat. ch. 868 (property tax rebates) and A.B. 1239 (Caldera), 1993 Cal. Stat. ch. 865 (property tax relief).

³ REV. & TAX. CODE §§25110, *et seq.*

⁴ Former REV. & TAX. CODE §25115.

⁵ *Barclay's Bank PLC v. California Franchise Tax Board*, 10 Cal. App. 4th 1742 (3d Dist. 1992), *cert. granted*, 62 U.S.L.W. 3311 (U.S. Nov. 1, 1993) (No. 92-1384); *Colgate-Palmolive Co. v. Franchise Tax Board*, 10 Cal. App. 4th 1768 (3d Dist. 1992), *cert. granted*, 62 U.S.L.W. 3311 (U.S. Nov. 1, 1993) (No. 92-1839).

⁶ *Hearing on S.B. 671 (Alquist)*, [1993 Cal. Stat. ch. 881; hereinafter S.B. 671] *before the California Assembly Committee on Revenue and Taxation* (Sept. 3, 1993).

⁷ *Barclay's Bank PLC v. Franchise Tax Board and Colgate-Palmolive Co. v. Franchise Tax Board*, 62 U.S.L.W. 4552, 1994 WL 266558 (June 20, 1994).

⁸ REV. & TAX. CODE §§25115(a), 18634, 25111(c).

⁹ *Hearing on S.B. 671 before the California Assembly Committee on Revenue and Taxation* (Sept. 3, 1993).

¹⁰ *Hearing on S.B. 671 before the California Senate Committee on Revenue and Taxation* (Aug. 18, 1993).

¹¹ *Hearing on S.B. 671 before the California Assembly Committee on Revenue and Taxation* (Sept. 3, 1993).

¹² S.B. 671 §§ 8, 21; REV. & TAX. CODE §§17271, 2444.

¹³ REV. & TAX. CODE §18152.5(a).

¹⁴ REV. & TAX. CODE §18152.5(b)(1).

¹⁵ REV. & TAX. CODE §§18152.5(c)(1), (d)(1)(B).

¹⁶ REV. & TAX. CODE §18152.5(e)(1)(A).

¹⁷ REV. & TAX. CODE §18152.5(e)(3)(A).

¹⁸ REV. & TAX. CODE §18152.5(e)(1)(A).

¹⁹ REV. & TAX. CODE §18152.5(e)(9).

²⁰ REV. & TAX. CODE §18152.5(c)(1).

²¹ S.B. 671, §29(a).

²² S.B. 671, §29(b).

²³ REV. & TAX. CODE §§17053.49(a)(1), 23649(a)(1).

²⁴ REV. & TAX. CODE §§17053.49(a)(2), 23649(a)(2).

²⁵ REV. & TAX. CODE §§17053.49(e)(1), (2), 23649(e)(1), (2).

²⁶ REV. & TAX. CODE §§17053.49(c)(1), 23649(c)(1).

²⁷ REV. & TAX. CODE §§6377(d); 17053.49(c)(2), 23649(c)(2).

²⁸ *Wilson Signs Landmark Legislation to Spur California Jobs*, BUSINESS WIRE, Oct. 6, 1993 [hereinafter BUSINESS WIRE].

²⁹ REV. & TAX. CODE §17053.49(d), 23649(d).

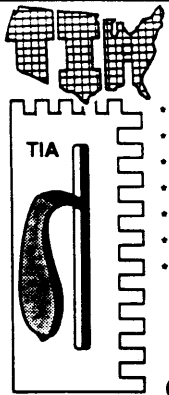
³⁰ REV. & TAX. CODE §6377(a) [flush language].

³¹ REV. & TAX. CODE §§6377(g)(2)(A), 17053.49(f)(2)(A), 23649(f)(2)(A).

³² REV. & TAX. CODE §§6377(g)(2)(B), 17053.49(f)(2)(B), 23649(f)(2)(B).

³³ REV. & TAX. CODE §§17053.49(f)(2)(A), 23649(f)(2)(A).

³⁴ *Hearing on S.B. 1292 (Alquist) before the California Senate Committee on Revenue and Taxation* (June 15, 1994).



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³⁵ REV. & TAX. CODE §23802(b)(1).

³⁶ S.B. 671, §20; REV. & TAX. CODE §23802(b)(1).

³⁷ REV. & TAX. CODE §§17052.12, 23609.

³⁸ BUSINESS WIRE, *supra* note 28.

³⁹ REV. & TAX. CODE §§17052.12, 23609.

⁴⁰ REV. & TAX. CODE §6380(b)(1)(C).

⁴¹ REV. & TAX. CODE §6380.

⁴² B. Inman, *Plans to Alter Little-Known Provisions of State Tax Code Rile Business*, L.A. TIMES, Mar. 21, 1993, at D2.

⁴³ *Id.*

⁴⁴ A.B. 34 (Klehs), 1993 Cal. Stat. ch. 880; S.B. 671, §9.5.

⁴⁵ S.B. 169 (Alquist), 1991 Cal. Stat. ch. 117; REV. & TAX. CODE §§17276.3, 24416.3.

⁴⁶ 1987 Cal. Stat. chs. 1138, 1139 (1987); I.R.C. §172(b)(1)(A)(i).

⁴⁷ *Hearing on A.B. 34 before the California Assembly Committee on Revenue and Taxation* (Apr. 12, 1993).

⁴⁸ *Id.*

⁴⁹ *Id.* The second rationale referred to the extension of the carryover period under federal law. Prior to 1976, federal law only permitted a three-year carryback and a five-year carryforward of NOLs. Under the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. 97-34, the carryover period was extended to 15 years with the justification that the extended depreciation deductions created by ERTA resulted in significant tax losses that required longer NOL carryover periods for utilization. California never conformed to these ERTA provisions, however.

⁵⁰ REV. & TAX. CODE §§17276(b)(2), 24416(b)(2).

⁵¹ REV. & TAX. CODE §§17276(d)(2), 24416(e)(2).

⁵² REV. & TAX. CODE §§17276(e)(2), 24416(f)(2).

⁵³ *Id.*

⁵⁴ *Hearing on A.B. 34 before the California Assembly Committee on Revenue and Taxation* (Apr. 12, 1993).

⁵⁵ *Hearing on A.B. 34 before the California Assembly Floor* (Sept. 3, 1993).

⁵⁶ *Hearing on A.B. 34 before the California Assembly Committee on Revenue and Taxation* (Apr. 12, 1993).

⁵⁷ *Assem. Floor Hearing, supra* note 55.

⁵⁸ REV. & TAX. CODE §§17276(d)(4), 24416(e)(4).

⁵⁹ REV. & TAX. CODE §§17276(d)(3), 24416(e)(3).

⁶⁰ 4 [Cal.] St. Tax. Rep. (CCH) ¶ 293-015.125.

⁶¹ REV. & TAX. CODE §25128.

⁶² L. Tatkin, *Legislation Alters Three-Factor Apportionment Formula, Double Weighting the Sales Factor*, 15 CAL. BUS. LAW REP. 246 (1994).

⁶³ REV. & TAX. CODE §§25128(a), (b).

⁶⁴ L. Tatkin, *supra* note 62.

⁶⁵ *Hearing on S.B. 1880 (Campbell) before the California Assembly Committee on Revenue and Taxation* (June 20, 1994).

⁶⁶ REV. & TAX. CODE §17955. See also *Hearing on S.B. 723 (Kopp)* [1993 Cal. Stat. ch. 874; hereinafter S.B. 723] *before the California Assembly Committee on Revenue and Taxation* (Aug. 16, 1993).

⁶⁷ *Hearing on S.B. 723 before the California Assembly Committee on Revenue and Taxation* (Aug. 16, 1993).

⁶⁸ Employment and Economic Incentive Act, 1984 Cal. Stat. ch. 44; Enterprise Zone Act, 1984 Cal. Stat. ch. 45; A.B. 38 (Archie-Hudson), 1992 Cal. Stat., 1st Exec. Sess., ch. 17; Local Military Base Recovery Act, 1993 Cal. Stat. ch. 1216.

⁶⁹ See generally 1 [Cal.] St. Tax. Rep. ¶15-980 (enterprise zones), ¶15-990 (Employment and Economic Incentive Act), ¶15-999 (Los Angeles Revitalization Zone), ¶15-999g (local military base recovery areas).

⁷⁰ D. Bernstein, *Wilson Signs Business Tax-Break Legislation*, SACRAMENTO BEE, Oct. 7, 1993, at A3 (quoting Lenny Goldberg, executive director of the California Tax Reform Association).

⁷¹ *Hearing on S.B. 671 before the California Assembly Floor* (Sept. 10, 1993).

⁷² S.B. 671, § 29(c).

⁷³ D. Bernstein, *supra* note 70.

⁷⁴ *Id.*