tax bulletin

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If you have any questions regarding this bulletin, please contact any member of our Tax and Wealth Planning Practice Group or one of the authors below.

Authors

Charles K. Kolstad
ckkolstad@Venable.com
310.229.9954

Alan J. Epstein
aepstein@Venable.com
310.229.0346

Robin C. Gilden
rcgilden@Venable.com
310.229.9967

California's New Tax Law Vastly Extends Its Taxing Reach

California made a number of amendments to the state's tax laws, affecting out-of-state taxpayers whose tax year began on or after January 1, 2011. As a result of these amendments, many out-of-state taxpayers will now be subject to California taxes. The changes impose significant information and record-keeping burdens on upper-tier partners as well as members of partnerships and LLCs. These taxpayers will have to determine whether they are subject to tax under the new rules by June 15 of this year to avoid penalties!

Under the new amendments, taxpayers will be considered to be doing business in California for California tax purposes if they satisfy one of four tests.

1. Is the taxpayer organized or commercially domiciled in California?
2. Do annual sales in California exceed the LESSER of $500,000 or 25% of total sales?
3. Does the value of real and tangible property in California exceed the LESSER of $50,000 or 25% of total property?
4. Does payroll in California exceeds the LESSER of $50,000 or 25% of total payroll?

Even if they fail to meet the four tests, they will still be required to pay taxes in California if they engage in ANY transaction for financial or pecuniary gain within the state.

Who Will Pay the New Tax?

So, any out-of-state taxpayer who has property or payroll in California of at least $50,001 is now subject to California tax. This includes both the minimum tax applicable to entities, and possibly its income tax and/or LLC fee. As noted above, an out-of-state taxpayer which actively engages in a single transaction in California will now be subject to California tax, even though it has no payroll or property and *de minimis* sales in CA.

Under the new rules, sales from services are classified as California sales if the purchaser of the service is located in California, regardless of where the services are performed. This could result in an out-of-state service partnership, such as a New York law firm, being subject to tax in California even though the services are performed outside of California and the firm has no property or payroll in California.

The changes also cause some strange results for out-of-state sellers of tangible personal property. An out-of-state seller may fall within the protection of P.L. 86-272, and thus not be subject to California taxes based upon income, such as the income tax or the franchise tax. However, if that same out-of-state seller meets one of the test set out above, it would still be subject to the California minimum tax, currently $800 per year, since that tax is based on doing business in California and not on net income!

A similar result occurs where an out-of-state taxpayer apportions all of its income to states other than California under the rules of R&TC 25136(a), since different apportionment and sourcing rules apply under R&TC 25136(b) for purposes of determining whether that same taxpayer is considered to be doing business in California. As a result, the taxpayer would not be subject to California's income tax, since none of its income would be apportioned to California for income tax purposes. However, the taxpayer would still be subject to California's minimum tax which is based upon whether or not the taxpayer is doing business in California.

Foreign LLCs which are classified as partnerships or disregarded entities may also be subject to the California $800 minimum tax because they are considered to be doing business in California, even though they are not subject to the California LLC fee since none of their income is apportioned to California.
What about pass-through entities such as partnerships and LLCs? Well, partnerships and LLCs will be considered to be doing business in California if any of their general partners or members are California residents. In addition, partners and members will be considered to be doing business in California if the partnership or LLC itself is doing business in California.

In determining whether any of the tests set out above are met, a partnership and LLC must take into account both its own California property, payroll and sales, as well as its share of California property, payroll and sales of any partnership and LLCs in which it is a partner or member. So, in order to determine whether an upper-tier partner or member is subject to California tax, it must investigate the California presence of each lower-tier partnership and LLC in which it is a direct or indirect partner or member. This could result in an upper-tier member, for example, being subject to California tax, because in aggregate it has more than $50,000 in California property, even though each of the lower-tier partnerships or LLCs themselves are not subject to California tax because they each have less than $50,000 in California property.

Requirements and Penalties

Taxpayers are required to make an estimated California minimum tax payment no later than the 15th day of the six month of each current taxable year (June 15th for a calendar year taxpayer). A 10% penalty will be imposed if the estimated minimum tax payment is less than the actual minimum tax payment, so we recommend that the full $800 minimum tax be paid through the estimated tax payment. California imposes penalties for failure to file the required corporate, individual, LLC or partnership tax returns.

In order to avoid penalties and interest on the unpaid taxes, out-of-state taxpayers should determine whether they are now subject to the new California rules, and thus required to pay the estimated California minimum tax by June 15, 2011.

For additional information, please contact the authors or any member of the **Venable Tax and Wealth Planning Group**.
