Tax Changes in the 2008-09 Budget
How Will They Impact Business?

Overview:

In light of recent developments indicating that the state's budgetary challenges are continuing and another special session may be necessary, our organizations believe it is important for decision-makers to have an understanding and appreciation of the impact of the recently-enacted budgetary tax law changes on the California business community.

As a result of the tax changes adopted as part of the 2008-09 Budget in AB 1452 and SBX1 28, California businesses will pay $5.8 billion more in taxes in 2008–09 and $1.6 billion more in 2009–10. These increases were effected through a combination of tax law changes that amount to interest-free borrowing and acceleration of tax revenues from businesses for the next two years and beyond.

While some offsetting reforms were also adopted, many companies investing in jobs and operations in California – or attempting to emerge from losses in the economic downturn – will suffer permanent harm.

What Are the Tax Changes?

1. Penalty for Reasonable Disputes (SBX1 28)

- **What is it?** A new 20% strict liability penalty in addition to all existing penalties, which applies to "understatements" of tax liability of $1 million or more. *Estimated to raise $1.5 billion from businesses.*
- **When?** May 2009 and stays in place *permanently*. Applies *retroactively* to tax year 2003.
- **How does it impact business?** Unlike most existing state and federal penalties, there is no "reasonable cause" exception, which makes this penalty applicable even to reasonable tax payer behavior where there is no culpability. This will force companies to overpay their taxes by May 2009 and subsequent years to include amounts reasonably in dispute, in order to ensure no 20% penalty. Overpayments will eventually be refunded, but the state will have received an interest-free or under-market rate loan.

2. Limit on Research & Development and Other Key Tax Credits (AB 1452)

- **What is it?** Two-year limit on the ability of businesses to use all business tax credits, including research and development, capping those credits at one-half of the taxpayer's tax liability. Very small businesses exempted. *Estimated to raise $900 million from businesses.*

- **When?** 2 years, 2008 and 2009.

- **How does it impact business?** This tax credit limitation will result in increased taxes for companies currently relying upon California's only remaining statewide investment incentive tax credits, research and development and enterprise zone credits. Credits that could have been used during the two-year limitation period are permitted to be carried over, but the lost time-value to companies is permanent.

- **Offsetting improvement.** Effective January 2010, tax credits (but not enterprise zone credits per SBX1 28) may be shared among a related group of affiliate or subsidiary companies, unitary utilization. This will help those companies that need the flexibility to allocate earned tax credits within their family of companies, but not all companies will benefit due to different circumstances and structures.

3. Suspension of Net Operating Loss (AB 1452)

- **What is it?** Suspends for two years the ability of businesses to deduct net operating losses (NOL). Very small businesses are exempted. *Estimated to raise $1.6 billion over two years from businesses.*

- **When?** 2 years, 2008 and 2009.

- **How does it impact business?** The NOL deduction gives businesses more flexibility to manage losses they experience within timeframes and cycles that differ from the arbitrary and rigid government tax filing deadlines. The suspension will directly impact marginally profitable businesses attempting to emerge from losses due to increased tax liability and reduced cash flow.

- **Offsetting improvement.** After the two-year suspension period, treatment of losses will fully conform to federal carryover and carryback, which will benefit some companies needing more flexibility in use of the NOL deduction.

4. Accelerated Estimated Tax Payments (SBX1 28)

- **What is it?** Business taxpayers must pay more of their estimated taxes earlier in the year. Instead of 4 payments of 25%, the first two payments will be 30% and the last two 20%. *Estimated to raise $2.3 billion from businesses.*

- **When?** Beginning January 2009 and permanently thereafter.

- **How does it impact business?** This will reduce cash flow for independent contractors and other businesses, small and large, in the first half of the year.

5. Accelerated Limited Liability Company Fee (AB 1452)

- **What is it?** Limited liability companies (LLC) must pay their annual fees during the first six months of the current tax year. A 10% penalty will be assessed if businesses underestimate. *Estimated to raise $360 million from businesses.*

- **When?** Beginning January 2009 and permanently thereafter.

- **How does it impact business?** Previously, a current year's LLC fee was due in the following tax year. The new fee deadline will result in a double payment of the fee in the early part of 2009 – the prior year's LLC fee and the current year's. This may pose a hardship for small companies with limited cash flow. Additionally, the LLC must estimate its following year's fee liability, or be subject to the 10% penalty.