The Great California TaxQuake!

The Commission on the 21st Century Economy Identifies Sweeping Tax Reforms That Could Shake Things Up for all California Taxpayers

On September 29, 2009, the Commission on the 21st Century Economy published its report to Governor Schwarzenegger outlining recommendations for a major shift in California's tax structure. The Governor created the Commission on October 30, 2008 when he signed Executive Order S-12-08 (later revised by S-15-09). This Commission's directive was to study and re-examine California's out of date revenue and taxation laws that contribute to California's feast-or-famine state budget cycles.

The Commission was established with six principles in mind:

1. Establish a 21st century tax structure that fits with the state's 21st century economy
2. Stabilize state revenues and reduce volatility
3. Promote the long-term economic prosperity of the state and its citizens
4. Improve California's ability to successfully compete with other states and nations for jobs and investments
5. Reflect principles of sound tax policy including simplicity, competitiveness, efficiency, predictability, stability, and ease of compliance and administration
6. Ensure that tax structure is fair and equitable

Since October, 2008 the Commission has met several times in order to craft a proposal and to hear public comment. The Commission hired an independent firm to analyze different states' alternative based taxes such as the Texas Margin Tax, the Ohio Commercial Activity Tax (CAT), and the Michigan Business Tax (MBT) to draw from the experience of states that have shifted away from a reliance on income taxes.

Overview of Proposal

The Commission divided its report into three sections:

1. Recommendations with consensus support of the Commission that require a change in statutory law and may be enacted by majority vote of the legislature (a revenue neutral package)

   The Commission's proposed plan for a new tax system that may require only a change in statutory law contains the following elements:

   - Simplify and reduce the personal income tax
   - Eliminate the corporate income tax and $800 minimum franchise tax completely
   - Eliminate the 5(1) percent state portion of the sales and use tax (the local county and district portion of the Sales Tax would remain intact)
   - Implement a new Business Net Receipts Tax (BNRT) to expand the tax base and keep revenues constant
   - Establish an independent tax court

   The new BNRT would expand the tax base to cover more taxpayers thereby spreading the overall tax burden over more taxpayers. Because the BNRT is not based on or measured by net income, it is intended to avoid significant swings in tax revenues that California has experienced over the last two decades. The revenue generated by the BNRT would replace the corporate income tax, the state portion of the sales and use tax, and reduced personal income taxes.

2. Recommendations with consensus support of the Commission that require a change in the state constitution or a ballot initiative:
   - Establish a Rainy Day Reserve Fund with a target reserve increased from 5 percent of revenues to 12.5 percent of revenues, plus a reserve for certain surpluses
   - Place restrictions on the ability to transfer funds into and out of the fund
3. Ideas worthy of further review but not recommended:
   - Earn revenue from royalties for offshore oil drilling leases
   - Require a new minimum tax on all residents and businesses
   - Merge the Board of Equalization and the Franchise Tax Board

The Main Proposal: A Sweeping Change to California's Taxes

Under the proposal by the Commission, the personal income tax would be simplified. The personal income tax changes would be phased-in and take effect in year three of the plan. The number of tax brackets would be reduced from six to two. Credits would be eliminated with the exception of taxes paid to other states. Deductions would be

limited to mortgage interest, property taxes, and charitable contributions. Two tax rates would exist: 2.75 percent of income up to $56,000 for joint filers ($28,000 for single filers), and 6.50 percent of income above these amounts. The standard deduction would be $45,000 for joint filers and $22,500 for single filers.

The corporate income tax would be completely eliminated for tax years starting on or before January 1, 2012. The state portion of the sales and use tax would be phased-out beginning with a 1 percent reduction in the initial year of the plan, and a 1 percent reduction during each of the four following years. This phased reduction of the rate contains a "safety valve" feature: the sales tax rate reduction is contingent upon equivalent tax revenue generated by a new BNRT, described below. If revenues fall short of projections, then the sales and use tax rate reduction would be adjusted to compensate.

Business Net Receipts Tax

The BNRT is designed to tax the value a business adds to the production of products and services sold in California. The BNRT is expected to shift $7 billion of tax liability outside of the state to those businesses selling into the California marketplace. The BNRT expands the tax base to impose the BNRT on business entities not currently subject to an income tax, and upon goods and services that currently escape sales or use taxes.

The BNRT would be imposed on all businesses deemed to be doing business in California if any of the following conditions are met:

- The business is organized or commercially domiciled in California.
- Sales by the business in California exceed the lesser of $500,000 or 25 percent of a taxpayer's total sales.
- The real property and tangible personal property of the business in California exceed the lesser of $50,000 or 25 percent of a taxpayer's total real property or tangible personal property.
- The amount paid in California by the employer for compensation exceeds the lesser of $50,000 or 25 percent of the total compensation paid by the taxpayer.

For pass-through entities, the BNRT liability would be deductible against the pass-through entity's income for purposes of calculating a partner's income tax liability. Thus, the partner's personal income tax base would include the pass-through income net of BNRT paid at the entity level.

The BNRT formula would be:

1. Gross Receipts – Purchases from Other Firms = Net Receipts
2. Net Receipts * BNRT Rate = BNRT Liability

The BNRT phase-in would be five years with the first year rate expected to be 1.6 percent. The Commission has also agreed on the need for a maximum tax rate which is expected to top off at 4 percent. There are several important points to recognize regarding this formula. There is no deduction for compensation or benefits for officers or employees. Any net operating loss, capital loss, and credit carryovers existing as of January 1, 2012, would be limited to 5 percent of a taxpayer's annual business net receipts, but could be carried forward 20 years until exhausted. However, in order to promote investment in California, the Commission has proposed to retain the research and development (R&D) credit.

- **BNRT Gross Receipts and Purchases for Non-Financials**
  The definition of gross receipts is meant to be interpreted broadly, but within the context of goods and

services sold by the taxpayer and consumed in the state. Thus, gross receipts include the sale and exchange of property, the performance of services, or the use of property or capital, including rents and royalties, in the trade or business of the taxpayer. Gross receipts would not include any receipts included in the measure of tax paid by any other taxpayer. Gross receipts would also exclude extraneous transactions that are not related to the sale of products or services, largely resulting from financial transactions. Some examples of the gross receipts exclusions are interest and dividends, maturity of a bond, or repayment of principal of a loan.

Purchases include only rents, royalties, inventory purchased for resale, materials and supplies, services purchased during the year and assets placed in service during the year. The amount deductible each year is limited to the amount immediately expensed or depreciated, amortized, or depleted during the year in accordance with federal law plus interest.

- **BNRT and Financial Businesses**
  Financial companies pose unique challenges to the BNRT. Because of these challenges the Commission has developed four potential options for taxing financial companies:

  1. Base the tax on the current corporation franchise and income tax laws.
  2. Base the tax on the calculation of BNRT on net income as defined under the provisions of the corporation franchise and income tax laws plus employee compensation.
  3. Base the tax on the calculation of BNRT using the same gross receipts factor as included for non-financials with the addition of interest amounts received pursuant to financial transactions and using the same purchases factor as included for non-financials with the addition of interest expenses on financial transactions.
  4. In addition to revenues and purchases in 3 above, include as revenues bank deposits and all proceeds from financial transactions and include as purchases loan amounts and financial purchases, except the purchase of own stock.

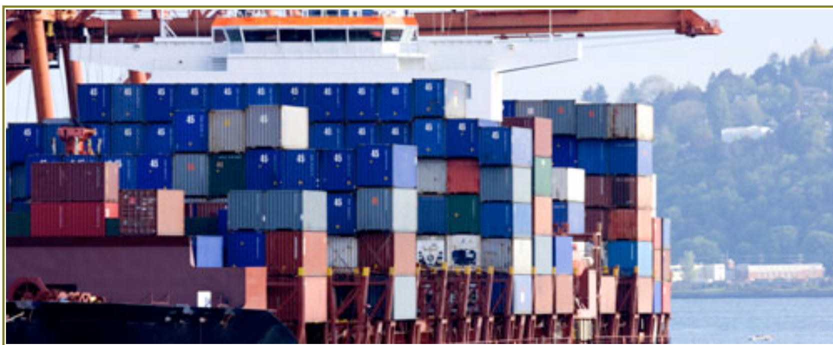
- **Unitary and Multi-State Business**
  The unitary method would still apply to unitary groups and multi-state businesses under the BNRT and it would still be water's edge. Multi-state apportionment would use a single sales factor. The taxpayer would have the option to base the apportionment calculation on just the current tax year's numbers or elect to use an average of the last five years.

Conclusion

The Commission report contains recommendations for sweeping changes to the California tax system, the merits of which will be considered by the legislature. It is too early to tell whether such a sweeping change would garner the required support to pass any or all of the Commission's recommendations. However, the undertaking itself has sent tremors across the State and beyond, potentially impacting all California taxpayers.

(1) It appears that the Commission bases this proposal on a 5% state sales and use tax rate (instead of the current 6% rate) in anticipation of a 1% reduction effective July 1, 2011.

IC DISCs: The Impact of Pending Legislation?



Interest charge domestic international sales corporations (IC-DISCs) have gained popularity in recent years among closely held businesses due to the elimination of other export incentives and the enactment of favorable tax rates.

Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRA), non-corporate shareholders of IC-DISCs are eligible for a 15 percent tax rate on qualified dividends while commisssions paid to the IC-DISC by the related exporter, and which are the source of the dividends, generate an ordinary income deduction at a 35 percent tax rate.

IC-DISCs now face an uncertain future. The favorable tax rates under JGTRA sunset for tax years beginning in 2011. Consequently, non-corporate shareholders will be subject to tax at ordinary income rates and the benefits of an IC-DISC will largely be eliminated. However, proposed legislation may give the IC-DISC a new life. The Obama Administration's fiscal year 2010 budget proposals would continue this benefit to IC-DISC non-corporate shareholders with a preferential 20 percent tax rate on dividends . With the uncertainty of future tax legislation, taxpayers with IC-DISC structures should continue to monitor these developments and be prepared to act defensively in the event that rates are allowed to increase. Specifically, IC-DISC distributions should be considered to lock-in the preferential dividend rate on accumulated IC-DISC earnings in advance of a possible increase in tax rates. The formation of a new IC-DISC may still be warranted to take advantage of the current low tax rates.

Background

The United States and its trading partners have enacted a variety of export tax incentives that have fallen victim to

attacks as illegal export subsidies. IC-DISCs came into existence in 1984 and have survived largely unscathed. The benefits of IC-DISCs are subject to an annual ceiling tied to $10 million of qualified export receipts. Until the favorable rates were enacted in 1993, the only benefit of an IC-DISC was tax deferral. Despite the benefits, the IC-DISC structure is not widely used. Specifically, public companies and widely-held private corporations (usually taxable as C corporations) are not eligible for the preferential rate on dividends from IC-DISC subsidiaries and it is impractical for them to have shareholder-owned IC-DISCs. Thus, the primary benefits currently accrue to closely held businesses engaged in exporting qualifying property. The aggregate subsidy to this group of businesses is not large enough to have attracted the attention of U.S. trading partners.

How Does It Work?

IC-DISCs are domestic corporations that are typically formed by a related party manufacturer (which can be a regular corporation or a pass-through entity) or its shareholders or partners. The IC-DISC is not required to have employees, maintain an office or have tangible assets, but must satisfy a number of technical requirements such as an asset test and a gross receipts test. In addition, the property of the related party supplier must satisfy a U.S. content requirement to be considered qualified exporting property. The IC-DISC receives a commission on qualified export receipts of a related party manufacturer, which in turn claims a deduction for the commission paid. IC-DISCs are not taxed on the commission income received, but instead their shareholders are taxed as they receive or are deemed to receive distributions. Distributions to an individual shareholder of the IC-DISC are generally taxed at the preferential rate for qualified dividends. An interest charge (at a very low rate) on deferred IC-DISC income is imputed to the extent that distributions are below the deferred income attributable to $10 million of qualified export receipts. The concept of tax deferral is a key component of the tax policy objectives behind the development of the IC-DISC provisions.

Example

U.S. Corporation X, an S corporation is engaged in the manufacture of qualified export property. The shareholders of X own 100 percent of an IC-DISC. In 2009, X generated $1,000 of qualified export receipts, paid the IC-DISC a $100 commission calculated under the IC-DISC rules, and the IC-DISC distributed $80 to its shareholders, retaining $20 for IC-DISC expenses such as advertising and export promotion. As a result, X shareholders' recognize a federal tax benefit of $35 relating to X's commission expense deduction and pay $12 tax on the qualified dividend from the IC-DISC. An interest charge (at a very low rate) would be imposed on the undistributed $20 of IC-DISC earnings that were not distributed, but retained for future IC-DISC business requirements.

Considering that IC-DISCs are relatively simple to form and administer, they can be an attractive option for any closely held business that generates qualified export receipts. The primary caveats are that the IC-DISC must be properly maintained under the IC-DISC technical tax provisions and that the uncertain tax legislature environment must be carefully monitored. Further, taxpayers should consider the interplay of relevant state income tax provisions before creating an IC-DISC.

As indicated, both the JGTRA sunset and the Administration's budget proposal would increase the tax rate on IC-DISC dividends. Independent legislation has also previously been introduced to eliminate the preferential tax rate on IC-DISC dividends. These various proposals create an uncertain legislative environment that necessitates careful planning. As a consequence, Taxpayers with IC-DISCs should consider making distributions, as otherwise appropriate, from the IC-DISC in the event legislation is not enacted to preserve the current favorable tax rate enjoyed by non-corporate IC-DISC shareholders.

Government-Sponsored Recovery Programs: A Compelling Opportunity for Investors?

The severe shocks that permeated the global economy and capital markets throughout the last 18 months have generated an unprecedented wave of policy actions by governments and central banks around the world.

In the United States, the current global financial crisis has compelled the Federal Reserve to slash lending rates to nearly zero amidst record fiscal stimulus being injected by the Federal government. The Fed has also launched a myriad of non-traditional, government-sponsored programs aimed at softening the landing of the worst recession in decades and remedying the ills associated with years of unrestrained consumer and business related overleveraging.

The most recent government program to make media headlines was the Car Allowance Rebate System (CARS), popularly referred to as "Cash for Clunkers." The terms, conditions, and possible benefits to consumers associated with the CARS program were rather simple and widely understood. For astute investors, there are other government-sponsored programs with more esoteric guidelines which may be worth some consideration. The size and scope of these programs also dwarf that of the popular CARS program. The $3 billion CARS government outlay is a drop in the bucket compared to the $700 billion commitment made to the Troubled Asset Relief Program (TARP) passed in 2008 and the over $200 billion commitments to the Term Asset-Backed Securities Loan Facility (TALF) and the Public-Private Investment Program (PPIP).

While the CARS program's narrow aim was to boost consumer spending, specifically automobile sales, the TALF and PPIP programs aim to stimulate lending by increasing the flow of consumer credit and by cleansing bank

balance sheets of their "toxic assets." Many economists believe that these broader goals must be achieved before the U.S. economy can recover and experience any substantial real GDP growth.

The TALF program currently provides financing to stimulate investor demand for asset-backed securities (ABS). The Fed finances the majority (between 85 and 95 percent) of the investor purchases of ABS, which represent newly issued triple-A securitizations(1) of collateralized pools of student loans, auto loans, credit card receivables, and small business loans. By incentivizing investor participation in the consumer credit markets, the Fed anticipates that increased demand will drive down spreads and increase consumer and business related lending activity. The TALF program recently extended its duration and modified its reach to include commercial mortgage-backed securities (CMBS), which could potentially extend the capacity of TALF to $1 trillion. The government's efforts may be starting to bear fruit as ABS and CMBS issuance has rebounded strongly and credit spreads have begun to narrow.

The PPIP is predicated on a belief that once banks rid their balance sheets of illiquid securities, they will have the confidence to increase their lending activity. Using capital partially funded through TARP and partially funded by private investors, the Treasury has approved nine asset managers to create Public-Private Investment Funds (PPIFs). PPIFs have some of the same core characteristics of a TALF fund (government co-investment, favorable financing terms, attractive yields), with a few important variations.

The major distinction between the TALF funds and the PPIFs is the origination of the underlying securities. While TALF restricts collateralization to newly issued securitizations, PPIFs will make investments in deeply discounted legacy assets(2). Due to this difference in origination, the risk and reward profiles of each program manifests itsself very differently. The PPIFs' universe of eligible securities is far larger than the TALF program, not being restricted by 2009 origination and initial credit rating. This allows PPIFs to purchase deeply discounted residential mortgage backed securities (RMBS) and lower rated CMBS with the opportunity for greater capital appreciation, along with a favorable yield from the underlying securities' current income component. The PPIFs may carry up to one times leverage, compared to the five to twenty times implemented by TALF funds. Since the TALF funds acquire triple-A rated ABS at a price close to, or at par, there is less opportunity for capital appreciation and more dependence on higher-leveraged income as the source of return. Further, due to the nature of their underlying investments and financing terms, the TALF funds will generally have a three-year lockup for investor principal compared to the eight to ten year lockup period for the PPIFs.

Market risk associated with the asset-backed sector is directly related to macro economic conditions and drivers such as unemployment, which has risen to levels perilously close to double digits in recent weeks. Possible future political pressures and the government's ability to make retrospective changes to the terms associated with these programs should also be considered.

The TALF and PPIP may offer appealing options for investors seeking an opportunity to participate in the currently dislocated markets. The benefits of these programs reside in the total return of eligible asset-backed securities and the highly attractive non-recourse financing terms provided by the Federal Reserve and the Treasury. The government's due diligence and monitoring of the selected managers provides a level of comfort and oversight. Some of the unique risks associated with these instruments should be further mitigated through the selection of asset managers possessing deep fundamental and qualitative resources and skills in the asset-backed and credit markets. Should the economy and credit markets continue to stabilize as they have in recent months, the TALF and PPIP programs may offer investors a very compelling credit related investment opportunity.

(1) Rated triple-A by at least two agencies
(2) Securities issued prior to the enactment of the government program

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The Impact of Healthcare Reform Legislation on Tax-Exempt Hospitals

Senate Finance Committee Chairman Max Baucus recently released the Chairman's Mark of the America's Healthy Future Act (the Mark).

The proposal includes changes to the requirements for Internal Revenue Code §501(c)(3) tax-exempt hospitals. The text of the changes was released on October 5th and is available on the Senate Finance Committee website here (pdf).

The new requirements apply to tax-exempt organizations that operate at least one hospital facility and are in addition to, and not in lieu of, the requirements that are otherwise applicable to such organizations. For purposes of the proposal, a hospital facility generally includes: (1) any facility that is, or is required to be, licensed, registered, or similarly recognized by a state as a hospital; and (2) any other facility or organization the Secretary of the Treasury (Secretary), in consultation with the Health and Human Services (HHS) Secretary and after public comment, determines has the provision of hospital care as its principal purpose. Each hospital facility would be required to comply with the provisions.

Community Health Needs Assessment

Each hospital facility must conduct or participate in a community-needs analysis at least once every three years and adopt an implementation strategy to meet the community needs identified through the assessment. The assessment process must take into account input from persons who represent the broad interests of the community served by the hospital, including those with special knowledge or expertise with respect to public health issues. The hospital

must disclose in its annual information report to the IRS (i.e., Form 990 and related schedules) how it is addressing the needs identified in the assessment and, if all identified needs are not addressed, the reasons why (e.g. lack of financial or human resources). Each hospital facility would be required to make the assessment widely available. This is not a new idea since a similar provision was included in the 1993 healthcare reform proposal.

Financial Assistance Policy

Each hospital facility would be required to adopt, implement, and widely publicize a written financial assistance policy. Each hospital facility would be required to adopt and implement a policy to provide nondiscriminatory emergency medical treatment to individuals. The financial assistance policy should indicate the eligibility criteria for financial assistance and whether such assistance includes free or discounted care. For those eligible for discounted care, the policy should indicate the basis for calculating the amounts that will be billed to such patients. The policy should also indicate how to apply for such assistance. If hospital does not have a separate billing and collections policy, the financial assistance policy must also indicate what actions the hospital may take in the event of non-response or non-payment, including collections action and reporting to credit rating agencies.

Limitation on Charges

Each hospital facility would be required to bill patients who qualify for financial assistance no more than the amount generally billed to insured patients. A hospital facility may not use a retail price (or chargemaster rate), when billing individuals who qualify for financial assistance. Instead, the amount billed to those who qualify for financial assistance must be based on either the best, an average of the three best, negotiated commercial rates, or Medicare rates.

Collection Processes

A hospital facility generally would be required to follow current Medicare law and regulations regarding collection of debts, but may not undertake certain extraordinary collection actions (even if otherwise permitted by law) against a patient without first making “reasonable attempts” to inform the patient about the hospital’s financial assistance policy. Such extraordinary collection actions would include lawsuits, liens on residences, arrests, body attachments, or other similar collection processes. It is intended that for this purpose, “reasonable attempts” would include notification by the hospital of its financial assistance policy upon admission and in written and oral communications with the patient regarding the patient’s bill, including invoices and telephone calls, before collection action or reporting to credit rating agencies is initiated.

Reporting and Disclosure Requirements

Under the Mark, the IRS would be required to review information about a hospital‘s community benefit activities (currently reported on Form 990, Schedule H) at least once every three years. Such review is intended to be similar to review of companies registered with the Securities and Exchange Commission. Each organization to which the Mark applies would be required to make its audited financial statements widely available. If an organization is included in consolidated financial statements, the consolidated entity’s audited financial statements must also be widely available.

The Mark would require the Secretary and the HHS Secretary to annually report to Congress the levels of charity care, bad debt expenses, unreimbursed costs of means-tested government programs, and unreimbursed costs of non-means tested government programs incurred by private tax-exempt, taxable, and governmental hospitals as

well as the cost of community benefit activities incurred by private tax-exempt hospitals. In addition, the Secretary, in conjunction with the HHS Secretary, must conduct a study of the trends in these amounts with the results of the study provided to Congress five years from date of enactment.

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