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California Tax | Alert

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FTB Sheds Light on the Allowability of CA Tax Credits and Deductions for Personal Income and Taxes Paid to Other States

The California Franchise Tax Board (FTB) has issued Legal Ruling 2017-01, a long, complex legal ruling which discusses the allowability of California tax credits and/or deductions for personal income and other taxes paid to other states in six hypothetical case studies. The ruling contains both cautions to taxpayers who have claimed credits where allowability is doubtful, and possible opportunities to claim refunds for certain state taxes paid that may not have been deducted in prior returns.

Five of the cases involve California resident individuals, trusts, or pass-through entities that incurred liability for taxes imposed by other states, and one involves an Arizona resident claiming a California tax credit for income derived from California sources. The ruling concludes that the Arizona resident is entitled to the claimed credit. In the other five cases (involving hypothetical taxes imposed by the states of Tennessee, Texas, Kentucky, and New York and by the Metropolitan Transportation Authority (MTA), a local agency chartered by New York State) the FTB holds that the credit is allowable in one case, partially allowable in one case, and not allowable in three cases, although a deduction is allowable in one of them. The ruling concerns only individual taxpayers, estates and trusts, and pass-through entities; it does not deal with apportionment of income or related issues affecting C corporations.

Background

The California personal income tax law provisions regarding allowable deductions generally conform to federal legislation, but with many exceptions, modifications, and special rules.[1] In particular, section 17220 of the California Revenue & Taxation Code (R&TC) denies the deduction authorized by section 164(a)(3) of the Internal Revenue Code (IRC) relating to "state and local and foreign income, war profits and excess profits taxes." Section 18001(a) of the R&TC generally allows a credit to California residents for "net income taxes imposed by and paid to any state (not including preference, alternative or minimum tax," on income from sources within that state that are taxable

[1] Cal. Rev. & Tax. Code § 17201.

irrespective of the residence or domicile of the recipient. Section 18002 of the R&TC allows nonresidents a credit for taxes paid to the state of residence if the state of residence authorizes a reciprocal credit to California residents or does not tax California residents on income derived from the state. The latter provision is intended to deal with a handful of states, including Arizona, Washington D.C., Oregon, and Virginia, known as "reverse credit" states, which allow nonresidents deriving income within their borders a credit for taxes paid to the state of residence on the same income.

Because the credit is allowable for "net income taxes," while the deduction is denied for "income taxes," certain taxes based on gross income are neither deductible nor creditable, according to both existing California case law and the FTB's discussion of the issue in the Legal Ruling.[2] However, taxes that are not based on or measured by "income" in any way are deductible if paid in connection with a business or investment activity, pursuant to the second full paragraph of section 164(a) of the IRC and section 17201 of the R&TC.

Where pass-through entities such as S corporations, partnerships (and limited liability companies taxed as partnerships), and trusts are involved, additional rules apply. Net income taxes imposed by states on S corporations and partnerships may be taken by California taxpayers as credits, as though they had been paid by the shareholder or partner directly. However, shareholders of S corporations are allowed this treatment only if the sister-state also treated the corporation as an S corporation, or did not allow S corporation status.[3]

In the case of estates and trusts, several statutory provisions may be relevant. With respect to taxes imposed on the estate or trust itself, if more than one state taxes its income, the trust or estate is considered a resident of all states that subject its income to tax for purposes of the income tax credit, but the California credit is limited both (i) to the portion of the taxes paid to the other state that the income subject to tax in both states bears to the total income taxable in the other state; and (ii) to the portion of California tax liability that the income subject to tax in both states bears to the total income taxable to California.[4]

Legal Ruling Analysis

According to the Legal Ruling, the first inquiry is whether the sister-state tax is imposed on, according to, or measured by "income," whether "gross" or "net." If it is not measured by income, then if the tax is imposed on or related to a trade, business, or investment activity, the tax is deductible. If it is measured by income, then a further inquiry is whether the tax is "properly characterized as a net income tax." If it is a net income tax, and the taxpayer has paid or is deemed to have paid it to the other state, a credit may be allowable. If it is not a net income tax, then it is neither deductible nor creditable.

The Legal Ruling also reviews a number of state court cases and California State Board of Equalization decisions[5], and notes that the character of a tax is determined by its operation, as interpreted by California under the principles of its statutes and case law, rather than by sister-state labels or determinations. It concludes that certain state taxes may be "multifaceted," so that some taxpayers might be able to treat the tax as not measured by income and therefore deductible, while other taxpayers might be able to argue that it was measured by net income and therefore creditable under some conditions. However, some taxes paid may not be deductible for some taxpayers. Others are considered a single levy, whose character as income vel non is determined for all taxpayers based on its primary characteristics. This means that some taxes may be deductible, if their primary character is that they are not based on income, even if in a particular case the tax is computed on the basis of gross or net income. Further, the principal determinant of whether a tax is based on income is whether, if it applies to manufacturing, mining, construction, retailing, or similar business dealing in commodities rather than services, an allowance is made for cost of goods sold. If that is the case, then the tax is based on or measured by "income," otherwise it is not considered to be based or measured by income.

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[2] *See Beamer v. Cal. Franchise Tax Board*, (1977) 19 Cal. 3d 467, 479; Cal. FTB Legal Ruling 2017-01 (Feb. 22, 2017).

[3] Cal. Rev. & Tax. Code 18006.

[4] *Id.* § 18003, 18004.

[5] See *Beamer*, supra n. 2; *MCA , Inc. v. Franchise Tax Board*, (2d Dist. 1981) 115 Cal. App. 3d 185, 171 Cal. Rptr. 242; *Robinson v. Franchise Tax Board* (3rd Dist. 1981), 120 Cal. App. 3d 72, 174 Cal. Rptr. 437.

Situations Addressed in the Legal Ruling

Situation One—An Arizona resident who is a partner in a partnership doing business only in California is entitled to credit the Arizona taxes paid on that income against the partner's California personal income tax liability. The California nonresident is allowed the credit for tax paid to Arizona because Arizona is a "reverse credit" state, which authorizes California residents doing business in Arizona to credit their California tax on the income derived there against their Arizona income tax liabilities.

Situation Two—An S corporation owned by a California resident does business in Tennessee, and pays a franchise tax which is measured by property value, and a $6,500 "excise tax" based on net earnings from the Tennessee business. The Legal Ruling concludes that the excise tax, but not the franchise tax, is creditable by the California owner. Although not discussed, it would appear that the Tennessee franchise tax is deductible by the S corporation for purposes of computing the California shareholder's income derived from it since it is not imposed on or measured by income.

Situation Three—An S corporation is engaged in construction contracting that does business in Texas and California, and an individual California resident owns 12 percent of the S corporation stock. The S corporation is liable for the Texas franchise tax, which according to the Legal Ruling, requires the taxpayer to compute its lowest "taxable margin." In some years, the lowest taxable margin can simply be a specified percentage of gross receipts, but in other years, the lowest taxable margin may result from subtracting cost of goods sold, but no other expenses or federally deductible amounts, from gross revenue. Regardless of which computation produces the tax base in a particular year, the Legal Ruling determines, following an elaborate discussion, that the Texas franchise tax is deductible in computing taxable income from the business for California personal income tax purposes, but is not creditable against California tax. The Legal Ruling determines that the Texas franchise tax is a single, indivisible tax rather than a "multifaceted tax," since it is imposed on all businesses, whether or not cost of goods sold is used to determine the tax base in a given year. Since the tax base can be determined without subtracting cost of goods sold, at least in some cases, it is not considered a tax on income. Accordingly, it is deductible if incurred by a business such as the instant corporation, but is not eligible for the California tax credit allowed for sister-state net income taxes.

Situation Four—A California resident trust is a member of an LLC that does business in New York City, among other places, and is subject to a tax imposed by the MTA which is based on payroll expenses. The Legal Ruling determines that the MTA tax is imposed on a base of payroll expenses, and as such is not creditable, since it is neither measured by net income nor imposed by a state, but rather by a local agency (the latter point may be erroneous, since the tax is imposed by state law and collected by the state (Sections 800 et seq. of the New York State Tax law). Although not stated in the Legal Ruling, it would seem that the tax is deductible in computing net income of the trust.

Situation Five—A California resident is a member of an LLC, which is treated as a partnership for tax purposes, which does business in Kentucky. The LLC pays a Kentucky tax based on the lesser of a percentage of gross receipts or a larger percentage of Kentucky gross profits. The Kentucky tax paid by the LLC is allowable as a credit against any individual income tax owed. In this situation, the California resident used the credit to satisfy its Kentucky personal income tax liability, and claimed the amount thereof on his California personal return, as though it were an actual tax payment. The Legal Ruling provides that there was no actual payment of tax, and accordingly, no credit in California can be claimed. The result seems unfair since the Kentucky scheme is economically similar to the situation where the entity pays a tax that is treated as a withholding from amounts otherwise distributable to its members, where the withholding amount is clearly creditable by the affected members.

Situation Six—A California resident trust sold its interest in a partnership that holds real property located in New York State. Under New York law, the transaction was considered to produce New York source income, while under California law (the so-called Amyas Ames doctrine)[6], it was deemed to be sourced in California as the sale of an intangible asset. Under a rule unique to trusts and estates, as opposed to individuals, the Legal Ruling determines that a credit is allowable against California tax for the New York tax paid, as limited by the provisions of Section 18004 of the R&TC, even though California law does not treat the gain as New York source income. A footnote states that the credit would

[6] Appeal of Amyas and Evelyn P. Ames, 87-SBE-042 (1987); see also Appeal of Amman & Schmid Finanz AG et al, 96-SBE-008 (1997) ; Appeal of Venture Communications, Inc. Cal. SBE ## 141641, 140415 (2003).

not be allowable to an individual, because section 18001, as contrasted with section 18004, requires that the creditable tax be on income deemed to have a situs in the other state pursuant to principles of California tax law. This statement may be subject to challenge under the decision of the Supreme Court of the United States in *Maryland Comptroller of Treasury v. Wynne*[7], strongly suggesting that credits for business done in other states may have be constitutionally required regarding nonallowability of the credit to individuals.

Potential Opportunities for Taxpayers

The Legal Ruling may provide some opportunities for taxpayers to claim deductions for taxes that are sometimes imposed on a base approximating gross income, but at other times on some other base, such as gross revenues (for entities that compute taxable income by reference to cost of goods sold, among other items) or payroll expenses. Individuals engaged in business activities in multiple states, including California, may wish to have their tax returns reviewed to determine whether refunds may be available. Other individuals who have claimed credits in California for taxes paid to other states which the ruling indicates are not eligible for credit should consider whether to file amended returns in order to avoid interest and penalties.

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[7] 135 S. Ct. 1787 (2014).

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