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Requested By: Residency Program, Audit Division
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SUBJECT: Availability of the Other State Tax Credit for S Corporation Shareholders for the Revised Texas Franchise Tax Cost of Goods Sold Method, The Ohio Commercial Activity Tax and the Michigan Business Tax

QUESTIONS PRESENTED

Whether the shareholders of an S corporation engaged in manufacturing are entitled to an other state tax credit (OSTC) for the following taxes paid for the 2008 tax year:

1. The Revised Texas Franchise Tax (RTFT) under the cost of goods sold (COGS) method
2. The Ohio Commercial Activity Tax (CAT)
3. The Michigan Business Tax (MBT).

CONCLUSIONS

S corporation shareholders are entitled to an OSTC for the RTFT computed under the COGS method and the business income tax portion of the MBT, which includes the portion of the annual surcharge attributable to the business income tax. However, S corporation shareholders are not entitled to an OSTC for the Ohio CAT or for the modified gross receipts portion of the MBT, which includes the portion of the annual surcharge attributable to modified gross receipts.

ANALYSIS AND DISCUSSION

S corporation shareholders are generally entitled to an OSTC for their pro rata share of taxes paid by the S corporation to another state if the tax is on, according to, or measured by income or profits paid or accrued.[1] Accordingly, each tax listed above must be analyzed to determine whether it constitutes an income tax under California law. While the term "income" is not specifically defined in the California Revenue and Taxation Code, the relevant case law indicates that a tax is an income tax if the base does not include a return of capital.[2]

The California courts have generally used gross income as the base line for identifying various taxes.[3] Gross income is broadly defined to include "all income from whatever source derived," unless otherwise provided.[4] Applying these principles, the California Supreme Court has stated that a gross receipts tax is a tax imposed on gross income and a return of capital, whereas a gross income tax is a tax imposed on gross income only, with any return of capital excluded from the tax base.[5] A net income tax is a tax imposed on the income that remains after gross income is reduced by deductions, credits, or exemptions.[6]

The United States Supreme Court and the California State Board of Equalization have also analyzed value added taxes (VATs).[7] Although there are various methods used to compute value added, it is generally defined as the increase in the value of goods and services brought about by what a business does to them between the time of purchase and the time of sale.[8] Unlike a corporate income tax, a VAT generally has no correlation to the taxpayer's ability to pay.[9] Accordingly, a VAT is not an income tax.[10]

A. The RTFT COGS Method

To determine the RTFT liability, each taxpayer computes its "margin" under three different methods and the lowest margin becomes the taxable margin.[11] One of these methods consists of total revenue less COGS ("COGS method").[12] To calculate total revenue, the taxpayer adds its gross receipts or sales, less returns and allowances, plus additional

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[1] Rev. & Tax. Code §§ 18001, subd. (b); 18006, subd. (b). Hereinafter, a tax on, according to, or measured by income or profits paid or accrued as described in California Revenue and Taxation Code section 18001(b) will be referred to as an "income tax."
[2] *Scott Beamer v. Franchise Tax Bd.* (1977) 19 Cal.3d 467 (*Beamer*) citing 1 Mertens, Law of Federal Income Taxation (1974) § 5.10, p. 36, fn 18.1; *Eisner v. Macomber* (1920) 252 U.S. 189, 208; *United States v. Safety Car Heating & Lighting Co.* (1936) 297 U.S. 88, 99.
[3] See. e.g., *Beamer*, *supra*, 19 Cal.3d 467; *Harry J. Gray v. Franchise Tax Bd.* (1991) 335 Cal.App.3d 36, 42-43 (*Gray*).
[4] Int.Rev. Code § 61; Rev. & Tax. Code § 24171.
[5] *Beamer*, *supra*, 19 Cal.3d 467.
[6] *Gray*, *supra*, 235 Cal.App.3d 36, 41-42.
[7] *Trinova Corporation v. Mich. Dept. of Treas.* (1991) 498 U.S. 358 (*Trinova*); *Appeal of Dayton Hudson Corporation*, 94-SBE-003, Feb. 3, 1994; *Appeal of Kelly Service, Inc. and Subsidiary Corporations*, 97-SBE-010, May 8, 1997.
[8] *Trinova*, *supra*, 498 U.S. 358, 362.
[9] *Ibid.*
[10] *Ibid.*
[11] Tex. Tax Code § 171.101. Under Tex. Tax Code § 171.1016, there is a fourth method, which can be used by taxpayers with $10 million or less in total revenue.
[12] *Id.*

income, and subtracts various items such as bad debt expense, foreign royalties and dividends, and Schedule C dividends and income from a related entity.[13]

Under Texas Tax Code section 171.1012(c), COGS includes all direct costs of acquiring or producing goods, including labor costs, depreciation, and costs of materials.[14] Accordingly, any return of capital is removed from the tax base under the COGS method. Therefore, the tax computed under the COGS method qualifies as an income tax and an S corporation shareholder would generally be entitled to an OSTC for his or her share of taxes paid by the S corporation to Texas.[15]

B. The Ohio CAT

The Ohio CAT is calculated by taking a percentage of taxable gross receipts less the applicable exclusion amount.[16] Gross receipts is defined as the total amount realized by the S corporation, without deduction for COGS or other expenses incurred, that contributes to the production of gross income of the S corporation, including the fair market value of any property or services rendered, and any debt transferred or forgiven as consideration.[17] Since the tax base includes a return of capital in the form of COGS, the tax is not an income tax. Therefore, an S corporation shareholder is not entitled to an OSTC for his or her share of the CAT paid to Ohio.

C. The MBT

The MBT includes two separate taxes on S corporations.[18] The business income tax is 4.95 percent of the business income tax base.[19] The business income tax base consists of the taxpayer's business income with certain adjustments.[20] Business income is defined as the part of federal taxable income derived from business activity.[21] Since none of the specified adjustments include the addition of a return of capital, the business income tax is an income tax. Therefore, an S corporation shareholder would generally be entitled to an OSTC for his or her pro rata share of the business income tax paid to Michigan.

The modified gross receipts tax is 0.80 percent of the modified gross receipts tax base, which generally consists of a taxpayer's gross receipts less purchases from other firms.[22] Purchases from other firms includes inventory acquired during the year, depreciable or amortizable assets acquired during the year, and other materials and supplies.[23] Since this

[13] Tex. Tax Code § 171.1011.
[14] Tex. Tax Code §171.1012, subds. (a), (c).
[15] Texas does not provide for an S corporation election. Therefore, the OSTC would be allowed under RTC section 18006(b)(2)(A).
[16] Ohio Rev. Code § 5751.03.
[17] Ohio Rev. Code § 5751.01, subd. (F).
[18] Mich. Comp. Laws § 208.1201; 208.1203.
[19] Mich. Comp. Laws § 208.1201.
[20] Mich. Comp. Laws § 208.1201, subd. (2).
[21] Mich. Comp. Laws § 208.1105, subd. (2).
[22] Mich. Comp. Laws § 208.1203, subd. (3).
[23] Mich. Comp. Laws § 208.1113, subd. (6).

computation is measuring the increase in the value of the goods brought about by what the S corporation did to the goods between the time of purchase and the time of sale, it is properly classified as a VAT. This is supported by the fact that the amount of tax is unrelated to the taxpayer's ability to pay. Therefore, the modified gross receipts tax is not an income tax and an S corporation shareholder would not be entitled to an OSTC for his or her pro rata share of the modified gross receipts tax paid to Michigan.

Additionally, for the years at issue, the MBT includes an annual surcharge in addition to these two taxes.[24] The surcharge is generally equal to 21.99 percent of the business income tax and the modified gross receipts tax liabilities.[25] Therefore, the portion attributable to the business income tax constitutes an income tax and the portion attributable to the modified gross receipts tax does not. Accordingly, S corporation shareholders would be entitled to an OSTC for the portion of the surcharge attributable to the business income tax, but would not be entitled to an OSTC for the portion attributable to the modified gross receipts tax.

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[24] Mich. Comp. Laws § 208.1281.
[25] Mich. Comp. Laws § 208.1281, subd. (1)(a).