STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Legal Division MS A260
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February 22, 2017

LEGAL RULING 2017- 01

SUBJECT: Tax treatment under Parts 10 and 11 of the California Revenue and Taxation Code (RTC) of taxes paid to another state for purposes of the California Other State Tax Credit (OSTC) and allowable deductions.

ISSUE

Under what circumstances may a taxpayer claim the OSTC or a deduction for taxes paid to another state?[1]

SITUATION ONE[2]

A is an Arizona resident and is a 25 percent partner in Z, a partnership that does business only in California. Z files a California partnership return of income reporting $100,000 of California-source income. A files an Arizona resident income tax return and reports her $25,000 pro rata share of Z's income, and pays tax to Arizona on this income totaling $2,500. A also files a California nonresident personal income tax return reporting her pro rata share of Z's income. A claims a $2,500 OSTC against her California income tax liability based on the tax that she paid to Arizona on her pro rata share of Z's income.

SITUATION TWO

D is a California resident and the sole shareholder of T, an S corporation that does business in Tennessee. T files a tax return in Tennessee paying both a $1,000 franchise tax, measured by the greater of net worth or the book value of real and tangible property located

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[1] This legal ruling addresses, among other things, the proper treatment of the Revised Texas Franchise Tax (RTFT) for purposes of the OSTC and deductibility under the RTC. Treatment of the RTFT was first addressed by the Franchise Tax Board (FTB) in FTB Notice 2009-06. FTB Notice 2009-06 was superseded and withdrawn by FTB Notice 2010-2. Subsequently, the Franchise Tax Board issued FTB Notice 2014-01, withdrawing FTB Notice 2010-2, and determined a Legal Ruling should be issued. As a result, this Legal Ruling replaces withdrawn FTB Notice 2010-02.

[2] The dollar amounts of tax, OSTC credit or deduction provided in this legal ruling are for illustration purposes only, and actual amounts may vary according to operative state law.

in Tennessee, and a $6,500 "excise" tax, which is based on the net earnings from business done in Tennessee. D files a California income tax return reporting his pro rata share of T's income. On his California personal income tax return, D claims an OSTC based on his pro rata share of the total franchise and excise taxes paid by T to Tennessee, or $7,500.

SITUATION THREE

R, an S corporation, is a general construction company doing business in Texas and California. Q, a California resident, is a shareholder owning 12 percent of R. R is subject to the Texas franchise tax, and has total revenues derived from construction projects, interest income earned on cash holdings, and consulting services. In computing its Texas tax base under Texas tax law, R must use its lowest taxable margin, which for year 1 is equal to 70 percent of its total revenue from its entire business. In year 2, R’s lowest taxable margin results from subtracting its cost of goods sold, as defined under Texas law, from its total revenue. R pays its Texas franchise taxes on the required taxable margin in years 1 and 2. R reports its apportioned income on its California franchise tax returns and deducts the franchise tax paid to Texas for taxable years 1 and 2. Q claims an OSTC against her California personal income tax liabilities for years 1 and 2, with respect to her pro rata share of R’s income, representing a 12 percent share of the Texas franchise tax paid by R in years 1 and 2.

SITUATION FOUR

X, an LLC taxed as a partnership, is an employer with business offices in several states, including an office in New York City (Manhattan). X is subject to the Metropolitan Commuter Transportation Mobility Tax (MCTMT) based on the payroll expense of its employees working in its Manhattan office. X pays the MCTMT to the New York State Tax Department. C is a trust with a non-contingent California resident beneficiary and a 25 percent member of X, receiving its distributive share of X's income. C does not distribute any of its income to its beneficiary. On its California fiduciary tax return, C claims an OSTC based on its pro rata share of the MCTMT paid by X.

SITUATION FIVE

B is a California resident and a member of Y, an LLC. Y does business in Kentucky and paid a Limited Liability Entity Tax (LLET) to Kentucky. The LLET is computed as the lesser of $0.095/$100 of Kentucky gross receipts or $0.75/$100 of Kentucky gross profits. Kentucky gross profits are defined as Kentucky gross receipts reduced by returns and allowances attributable to Kentucky gross receipts, less the cost of goods sold attributable to Kentucky gross receipts. Under Kentucky law, an individual who is a member, shareholder, or partner of a limited liability pass through entity shall be allowed a nonrefundable LLET credit equal to the individual’s proportionate share of the entity's LLET after it is reduced by the minimum tax due of $175 and any other nonrefundable credits. B reported an income tax liability (before credits) to Kentucky based on his distributive share of Y's income, and used, as provided under Kentucky law, his proportionate share of the Kentucky LLET credit to fully satisfy his personal income tax liability owed to Kentucky. B filed a California income tax return claiming an OSTC based on the amount of the LLET credit used to fully satisfy his Kentucky income tax liability.

SITUATION SIX

P is a trust that is a partner in M, a partnership holding real property located in New York. P's sole, non-contingent beneficiary is a California resident, O. P sells its partnership interest in M and does not distribute the gain from the sale of its interest in M to O. New York law sources the gain on the sale of P's interest in M to New York, while California law sources the gain on the sale of that interest to California. P properly reports the gain on the sale of its interest in M on its New York fiduciary tax return, and pays the tax on the gain to New York. P also properly reports the gain on the sale of its interest in M on its California fiduciary tax return and claims an OSTC for the amount of tax paid to New York on the gain.

LAW AND ANALYSIS

General OSTC Rules

Assuming specific California statutory requirements are satisfied, California allows an OSTC to alleviate double taxation.[3] Tax credits are "strictly matters of legislative grace and are to be construed against the taxpayer."[4] The statutory requirements for entitlement to the credit vary, depending on the residency and status of the taxpayer, as follows:

OSTC for a California resident: An OSTC is allowed for *net income taxes* imposed by and paid to another state on income that is also taxed by California, where that income is derived from sources within the other taxing state, and the other state does not allow California residents a credit against the taxes imposed by that state for taxes paid to California.[5]

OSTC for a California nonresident: An OSTC is allowed for *net income taxes* imposed by and paid to the taxpayer's state of residence on income that is also taxed by California, if the state of residence either: (a) does not tax the income of California residents derived from sources within that state; or (b) allows California residents an OSTC against the taxes imposed by that state on income derived from sources within that state.[6] However, an OSTC is not allowed for taxes paid to a state that allows its residents an OSTC for net tax paid to California irrespective of whether its residents are allowed a California OSTC.[7]

OSTC for a California resident or nonresident S corporation shareholder: An OSTC is allowed for the taxpayer's pro rata share of *any taxes on, or according to, or measured by the S*

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[3] See Rev. & Tax. Code, §§ 18001-18011; Cal. Code of Regs., tit. 18, §§ 18001-1, 18001-2; FTB Schedule S.

[4] *Christman v. Franchise Tax Bd.* (1976) 64 Cal.App.3d 751, 757; *Miller v. McColgan* (1941) 17 Cal.2d. 432.

[5] Rev. & Tax. Code, § 18001, subd. (a) and (c).

[6] Rev. & Tax. Code, § 18001, subd. (a)(1).

[7] Rev. & Tax. Code, § 18002, subd. (a)(2).

corporation's income or profits that are paid by an S corporation to the other state.[8] Therefore, this OSTC is available for taxes imposed by and paid by the S corporation to the other state on *gross income* or *net income*. Furthermore, the other state imposing the tax must either:

(1) Not allow a corporation to make an election to be treated as an S corporation, or
(2) Impose a tax on S corporations, and the S corporation in question must have elected (or have been required) to be treated as an S corporation in the other state, as well as in California.[9]

OSTC for a California resident or nonresident partner in a partnership or member in an LLC taxed as a partnership: An OSTC is available for the taxpayer's pro rata share of *net income taxes* paid to the other state by the partnership or LLC, as if those taxes had been paid directly by the taxpayer who is a partner or a member.[10]

OSTC for a California resident estate or trust: If a California resident estate or trust is also a resident of another state, an OSTC is available for net income taxes paid to the other state.[11] The California resident estate or trust that is also a resident of another state can claim the OSTC when the income that is subject to double taxation is sourced either to California or the other state.

OSTC for a California resident beneficiary of an estate or trust: An OSTC is available to the California resident beneficiary of an estate or trust for net income taxes paid by the estate or trust to another state, assuming the beneficiary is taxable on income of the estate or trust under RTC sections 17731–17779.[12]

General Deduction Rules

Neither an individual, an entity taxed as a partnership, nor a corporation can deduct gross income or net income taxes paid to another state.[13] A deduction is available for taxes not on, or according to, or measured by income or profits (a measure based on income, which includes gross and net income taxes) imposed by and paid to another state by an individual, an entity taxed as a partnership, or a corporation in connection with "carrying on a trade or business" or "for production of income," with certain exceptions.[14]

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[8] Rev. & Tax. Code, §§ 18001, 18006, subd. (b). The italicized language excludes a gross receipts tax. See *Beamer v. Franchise Tax Bd.* (1977) 19 Cal.3d 467, 479 *("Beamer")*.

[9] Rev. & Tax. Code, §§ 18006, subd. (b)(2)(A) and (B).

[10] Rev. & Tax. Code, §§ 18001, subd. (a), and 18006, subd. (a).

[11] Rev. & Tax. Code, § 18004.

[12] Rev. & Tax. Code, § 18005.

[13] Rev. & Tax. Code, §§ 17201, 17220, 17853, 24345, subd. (b); *Beamer, supra*, at 479-480.

[14] Rev. & Tax. Code, §§ 17201, 24345; *Beamer*, *supra,* at 474.

Determination as to Whether the OSTC or Deduction is Permitted

As set forth above, the determination as to whether the payment of a tax to a sister-state is eligible for the OSTC or is deductible for California purposes turns on: (1) whether the tax is properly characterized as a tax on, or according to, or measured by income; and if it is, (2) whether the tax is properly characterized as a net income tax. If the tax is not properly characterized as a tax on, or according to, or measured by income, then the inquiry ends, and the taxpayer may claim a California deduction for the tax, assuming all other requirements are met, but the taxpayer may not claim the OSTC. If the tax is properly characterized as a net income tax, a further determination must be made as to whether the tax is imposed by and paid to the other state such that the taxpayer may claim the OSTC. With respect to a shareholder of an S corporation that is doing business in another state, if the S corporation is subject to and pays a tax characterized as a tax on, or according to, or measured by income (a gross income tax), then the S corporation shareholder might also be able to claim the OSTC for his or her pro rata share of the S corporation's tax, provided all other criteria are met.

In situations where the other state's tax is not a single, indivisible tax, but rather a multifaceted tax consisting of a conglomeration of "separate and independent taxes"[15] to which a taxpayer is concurrently subject with respect to the same taxable year, each of the separate taxes is analyzed independently. Thus, it is possible for some portion of a multifaceted tax to be based on net income such that it is eligible for the OSTC and not deductible, while another portion is not based on income and is deductible, but not eligible for the OSTC. The determination as to the characterization of a multifaceted tax is discussed further below.

Determining the Character of a Tax

The proper characterization of a tax is determined by its operation, not its labels.[16] A tax is analyzed by applying general tax law, including applicable federal and California authorities.[17] When determining how a sister-state's tax should be characterized for California purposes, the general tax law utilizing California income tax principles[18] must be applied, rather than a characterization that might be utilized by the sister-state. Therefore, when determining how to treat sister-state taxes for purposes of the OSTC or for a tax deduction, the characterization and analysis of the other state's tax is not dictated by the other's state's denomination or judicial characterization of that tax as an "income" or "gross receipts" tax.[19]

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[15] *Trinova Corp. v. Michigan Dept. of Treas*. (1991) 498 U.S. 358, 374-375.

[16] *Beamer, supra,* at 475.

[17] *Ibid.*; *MCA, Inc. v. Franchise Tax Bd.* (1981) 115 Cal.App.3d 185 ("*MCA*"); *Robinson v. Franchise Tax Bd.* (1981) 120 Cal.App.3d 72 ("*Robinson*"); *Gray v. Franchise Tax Bd.* (1991) 235 Cal.App.3d 36 ("*Gray*").

[18] *Christman v. Franchise Tax Bd*., *supra*, at 757; *Robinson*, *supra*, at 81.

[19] *Beamer, supra*, at 479-480.

California case law provides that the determination of whether a tax is a gross income tax is made by reviewing the other state's entire statutory methodology. As such, the tax base as a whole is analyzed, and the characterization is universal for all taxpayers, rather than a unique taxpayer by taxpayer characterization of the other state's taxing regime. Case law requires that the analysis consider the potential components of the taxable base when determining whether a tax is a gross income tax, "regardless of the specific components of the … tax base of the taxpayer claiming the deduction."[20] California courts and the California State Board of Equalization have rejected a taxpayer-by-taxpayer review and characterization of whether or not a tax is a gross income tax.

Is the Tax on, or According to, or Measured by Income?

The determination of whether a tax is on, or according to, or measured by income depends on what activity or activities, and the potential tax base, to which the tax applies. When a state's tax mechanism provides for a taxable base that includes earnings from manufacturing, merchandising, or mining, the characterization of the tax as having a measure based on income (non-deductible) or some other base (such as a gross receipts), depends on whether cost of goods sold (COGS), or a return on capital, could be included, under the other state's tax mechanism, in the tax base.[21] In contrast, where a tax base could not include proceeds from an activity that has COGS associated with it, and the tax only applies to items such as royalties, rent, interest, and/or dividends, the characterization of the tax must be, by definition, a tax on, or according to, or measured by income. This distinction based on the other state's tax structure remains true even if the gross income of a particular taxpayer is equal to that taxpayer's gross receipts, and the fact that a tax's measure based on gross receipts or some other measure might coincidently also equal gross income for a particular taxpayer does not automatically convert that tax into a tax on, or according to, or measured by income, or vice-versa.[22]

That the classification of a tax is based on the overall mechanism of each state's tax methodology, and not on a taxpayer-by-taxpayer basis according to the items actually taxed in a specific instance, was demonstrated by the contradictory results of tax characterization found in *Beamer, supra*, and *MCA, supra*. In both *Beamer* and the subsequent case, *MCA,* the taxpayers claiming deductions for taxes paid received royalty income subject to tax. However, in *Beamer*, due to the overall operation of the Texas statute, no deduction for "lifting" or production costs was allowed in computing the taxable base. The *Beamer* court found that the tax was not on, or according to, or measured by income by reference to the overall tax base calculation mechanism, with the result that the Texas tax was deductible, notwithstanding that the taxpayer had only received a royalty payment. However, in *MCA*, as the tax was imposed specifically on royalties, and as "royalties" are specifically defined in Internal Revenue Code (IRC) section 61 as an item of gross income, the *MCA* court found that the tax was a gross income tax, and denied the taxpayer the claimed deduction. Thus, even though a particular taxpayer may exclusively and ultimately be taxed on an item defined in the IRC as an item of gross income, such as a royalty, the item that is actually

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[20] *Appeal of Kelly Services, Inc.,* 97-SBE-010, May 9, 1997 (*Kelly Services*).

[21] *Robinson, supra*, at 81.

[22] *Beamer, supra*, at 480. See also *MCA, supra*, at 198.

taxed is not determinative of the tax's characterization.[23] Even though the same item (royalty payment) was being taxed in both cases, the resulting tax characterization was completely different, due to the overall operation of each jurisdiction's tax mechanism and allowances. As the tax base in *MCA, supra*, was limited to rent and royalties, items enumerated in IRC section 61 as items of gross income, the court found the tax at issue was a gross income tax, and therefore not deductible under RTC section 24345.

Accordingly, a tax is characterized universally for all taxpayers. It is the statutory operation as a whole, and the *potential* for an item that is not "gross income" to be taxed, that determines the tax's characterization as a gross income tax, or not. In affirming the universal characterization of a particular tax, as opposed to utilizing a taxpayer-by-taxpayer characterization, the *Robinson* court reviewed the *Beamer* decision and stated:

> Taxpayers misread *Beamer*. The issue there was whether Texas *law* permitted deduction of lifting costs, not whether Beamer had any and, consequently, whether the Texas law, measured by general tax law, was a tax on gross income.[24]

Thus, a case-by-case analysis of a particular taxpayer's situation is not appropriate and is not determinative of whether a tax has a measure based on income; rather, the other state's taxing scheme in general must be reviewed to determine whether or not there is a potential for any taxpayer, not a particular taxpayer, subject to the tax to be taxed on a base that is on, or according to, or measured by income or profits.[25]

California case law has illustrated the application of these rules to various taxes on different types of business activities. In *Beamer*, the California Supreme Court examined whether a group of taxpayers (trust beneficiaries) were entitled to a deduction under former RTC section 17204(c)(4)[26] for a Texas tax on oil and gas producers.[27] The court explained that if the Texas tax was a tax on or measured by income, a deduction would not be permitted.[28] The Texas tax only applied to the business activity of oil and gas production and was calculated as a percentage of the market value of the oil when produced.[29]

Because Treasury Regulation section 1.61-3(a) defines gross income with respect to mining as specifically excluding the COGS from total sales, and as the Texas tax was imposed on producers of oil and gas, activities the court considered analogous to mining, the court determined that the Texas tax would only be a gross income tax if it provided for a

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[23] *Beamer*, *supra*.

[24] *Robinson*, *supra*, at fn. 9.

[25] *Appeal of Kelly Services*, *supra*; *Robinson*, *supra*, at fn. 9.

[26] Former RTC section 17204(c) provided: "No deduction shall be allowed for… Taxes on or according to or measured by income or profits paid or accrued…."

[27] *Beamer, supra*.

[28] *Beamer, supra*, at 474.

[29] *Beamer, supra*, at 475.

deduction for COGS.[30] The court explained that in the context of oil and gas production, lifting costs are the COGS.[31] Since the Texas tax did not permit a deduction for lifting costs, the court held it could not be a gross income tax.[32] As a result, the taxpayers were entitled to deduct the Texas tax in determining their California taxable income.[33]

Subsequently, in *MCA*, the Second Appellate District analyzed various foreign taxes on the gross amount of film rents and royalties where no deduction was provided for expenses incurred in producing the rents and royalties.[34] The court determined that since the definition of gross income explicitly includes rents and royalties, the tax must be a gross income tax regardless of the fact that the amount taxed also equaled *MCA's* gross receipts.[35] Therefore, the taxpayer in *MCA* was not entitled to a deduction under RTC section 24345 for the taxes paid, as the taxes were a tax on, or according to, or measured by income (i.e., measured by gross income).

Shortly after *MCA*, the Third Appellate District decided a similar deduction issue in *Robinson*.[36] In *Robinson*, the taxpayers earned income from a trust that consisted mostly of rental and interest income, which was subject to the Hawaii general excise tax.[37] The Hawaii general excise tax varied with the business activity, and subjected some of the different activities to different tax rates.[38] For example, there was a "tax on manufacturers," a "tax on contractors," a "tax on service businesses," etc.[39] Because the majority of the taxpayers' income consisted of rents and interest, the court focused on the deductibility of the tax on these items and explicitly stated that rents and interest are "specifically listed as gross income in the California and federal statutes."[40] Under the Hawaii tax, all proceeds from rents were included in the tax base without any reduction for costs.[41] The *Robinson* court noted that "[s]ince the definition of rent excludes a return of capital or cost of goods sold, it is, of course, immaterial that the Hawaii law also does not

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[30] *Beamer, supra*, at 476-477, 480. Former California Code of Regulations, title 18, section 17071(c) was identical to Treasury Regulation section 1.61-3(a). While this regulation was repealed, California still conforms to Treasury Regulation section 1.61-3(a) by virtue of its conformity to IRC section 61. (Rev. & Tax. Code, §§ 17024.5(d), 23051.5(d).)

[31] *Beamer, supra*, at 477.

[32] *Beamer, supra*, at 480.

[33] *Ibid*.

[34] *MCA, supra*.

[35] *MCA, supra*, at 198.

[36] *Robinson, supra*.

[37] *Robinson, supra*, at 75, 81.

[38] *Robinson, supra*, at 80; Haw. Rev. Stat., § 237-13.

[39] Haw. Rev. Stat., § 237-13.

[40] *Robinson, supra*, at 82.

[41] *Ibid*.

permit a deduction of such items *from* rent."[42] Accordingly, the *Robinson* court determined the Hawaii tax on rental income was a nondeductible gross income tax.[43]

The California State Board of Equalization (the Board) utilized the holdings in these cases in analyzing the deductibility of the Michigan Single Business Tax (MSBT) in the *Appeal of Dayton Hudson Corporation (Dayton Hudson)*[44] and the *Appeal of Kelly Services.*[45] Unlike the circumstances in *Beamer*, *MCA*, and *Robinson*, where the taxes only applied to specific business activities, the MSBT was a tax on many types of business activities, including manufacturers, merchandisers, miners, and service providers.[46] The MSBT started with federal taxable income and added back various items, including labor, depreciation, and interest.[47]

In *Dayton Hudson*, the taxpayer was a merchandiser who argued that the MSBT was deductible because it included a portion of COGS in the tax base in the form of “labor cost of goods sold.” Because compensation was added back into the tax base without any deductions, the Board determined that there was an element of return of capital in the tax base in the form of labor cost of goods sold. Citing *Beamer* and *Robinson*, the Board determined this element of COGS was sufficient to find that the tax was not on or measured by income. Therefore, the taxpayer was entitled to a deduction for the taxes paid.

In *Kelly Services*, the taxpayer was primarily a service provider. As a service provider, there was no return of capital in its line of business, unlike the manufacturer in *Dayton Hudson*. In its analysis, the Board explained that the MSBT does not allow a deduction for many items routinely deducted for income tax purposes, which broadened the tax base beyond profits and drew other components of the taxpayer’s economic activity (labor, capital, financial) into the tax base. However, the inclusion of labor COGS in the statutory tax base, notwithstanding the particular taxpayer's lack of COGS, drove the Board’s conclusion that the MSBT was taxing something other than gross income. As a result, the taxpayer was entitled to a deduction for the taxes paid. The Board found it irrelevant that the taxpayer itself did not have inventory costs as a service provider, because the inquiry for characterizing a tax as one on gross or net income, or not, surrounds the tax base in general rather than as applied to a particular taxpayer. Since the MSBT base calculation applied correspondingly to manufacturers and service providers, it was possible for an element of COGS, in the form of labor COGS, to be in the MSBT base under the format of the Michigan tax regime.

These cases illustrate the general rule that when a tax base includes, or could include, income from manufacturing, mining or merchandising, the characterization of the tax as a

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[42] *Ibid.*

[43] *Ibid*.

[44] *Appeal of Dayton Hudson Corp.*, 94-SBE-003, Feb. 3, 1994.

[45] *Appeal of Kelly Services*, *supra*.

[46] See *Trinova Corp. v. Michigan Dept. of Treas., supra*, at 367.

[47] *Appeal of Dayton Hudson*, *supra*.

gross income tax depends on whether the statutory scheme as applied to all taxpayers removes COGS from the tax base. In contrast, when a tax base could not include income from manufacturing, mining, or merchandising, and only consists of income items such as rents, interest, or dividends, the characterization of the tax must, by definition, be an income tax. As explained in *MCA*, this is true even if the gross income of a particular taxpayer is equal to that taxpayer's gross receipts.[48]

Determining the Character of a "Multifaceted" Tax

As discussed above, when a tax is not a single, indivisible tax, but rather a conglomeration of "separate and independent taxes,"[49] the character of each of the separate taxes is analyzed independently.

The determination as to whether a tax is multifaceted turns on whether the tax imposed can be segregated into multiple portions as a result of the operation of the taxing scheme. One such indication of a multifaceted tax is whether the tax imposes two or more tax rates on different tax bases, depending on which business activity is taxed. If a state's tax system aggregates various items of revenue or income within one tax base, and subjects that base to one level of tax, then that state does not impose a multifaceted tax, even if a particular taxpayer only realizes and pays tax on one item of income, in contrast to a different taxpayer also subject to that same tax on a different item of income or revenue. As analyzed above, tax systems are characterized on the entire potential tax base, not on a particular taxpayer's tax base.

In *Robinson, t*he Hawaii general excise tax base varied with the business activity taxed.[50] Because the different business activities resulted in a variety of taxes (some of varying rates) applicable to segregated measures, or bases, of tax, which comprise the Hawaii general excise tax, the court determined that the tax was multifaceted.[51] Thus, the Hawaiian tax on rents was a tax on a base comprised of gross income under the general tax law, and was nondeductible. However, other tax bases comprised of proceeds from other business activities, such as sales proceeds derived from mining business activities, from which the Hawaiian statute failed to exclude the cost of goods sold, provided a tax on, or according to, or measured by something other than income, with the result that that portion of tax would be deductible.

In contrast, the Supreme Court in *Trinova*, and the Board in *Dayton Hudson*, declared that the MSBT was not a multifaceted tax composed of separate and independent taxes, but rather was an indivisible tax on one measure. The Supreme Court in *Trinova* was asked to

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[48] *MCA, supra*, at 198.

[49] *Trinova Corp. v. Michigan Dept. of Treas.*, *supra*, at 375.

[50] *Robinson, supra*, at 80; Haw. Rev. Stat., § 237-13.

[51] *Robinson, supra*, at fn. 9. "Taxpayers misread *Beamer*. The issue there was whether Texas *law* permitted deduction of lifting costs, not whether Beamer had any and, consequently, whether the Texas *law*, measured by general tax law, was a tax on gross income." (Emphasis on "law" added by *Robinson* court.)

decide whether the MSBT could be broken into three smaller taxes based on the three-factor apportionment formula, to determine whether the tax was multifaceted. The Supreme Court rejected the argument that the MSBT could be divided into three separate and independent taxes on the basis of the apportionment computation method, stating the tax "is an indivisible tax upon a different, bona fide measure of business activity, the value added."[52]

Thus, for a tax to be considered multifaceted, it must be able to be divided into multiple smaller, separate, independent taxes, with statutorily separated tax bases. Only when a tax is multifaceted can a particular tax be bifurcated such that a portion of the tax is on, or according to, or measured by income while another portion is not, and those divisible portions are separately analyzed for their character. If a tax is a single, indivisible tax, the tax cannot be bifurcated into different bases that are on, or according to, or measured by income, and those that are not on, or according to, or measured by income; as a result, the tax as a whole is analyzed for its sole character. Thus, a state's tax that applies to a variety of items does not become "multifaceted," nor is it characterized differently among different taxpayers simply because one taxpayer's base consists solely of items described in IRC section 61(a), in contrast to another taxpayer's base comprised of different items. Rather, as explained above, the other state's taxing scheme in general must be reviewed to determine whether there is a potential for any taxpayer subject to the tax to be taxed on a base that is on, or according to, or measured by income or profits.

Is the Tax a Net Income Tax?

After it is determined a tax is on, or according to, or measured by income, before the tax is eligible for the OSTC, that tax must be evaluated to determine whether it is also a net income tax.[53] Generally, certain deductions must be present for a tax to be considered a net income tax eligible for the OSTC. In the *Appeal of Covert, Jr. and Laura J. Robertson*, the Board analyzed a different Michigan tax, the Michigan Business Activities Tax (MBAT).[54] The MBAT was imposed on an entity's "adjusted receipts," which were defined as the gross receipts from business less various considerable deductions. However, no deduction was allowed for wages; except if wages exceeded 50 percent of gross receipts, then a deduction of 10 percent of the gross receipts or half of the excess, whichever was smaller, was taken in addition to the other basic deductions. The Board found that a deduction for the entire cost of wages is a basic requirement in arriving at the net income of a business. As such, a tax that does not allow a full deduction for wages paid is not a net income tax and is not eligible for the OSTC.

Moreover, in distinguishing whether a tax is a "net income" tax or not, California courts look to whether the other state allows other deductions from the tax base beyond IRC section

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[52] *Trinova*, *supra*, at 375.

[53] As discussed above, when determining the net income taxes imposed by and paid to another state by an S corporation, net income taxes for S corporation shareholders include the shareholders' pro rata share of any taxes on, according to, or measured by the S corporation's income or profits, paid or accrued, pursuant to RTC section 18006, subdivision (b).

[54] *Appeal of Covert, Jr. and Laura J. Robertson*, 60-SBE-038, Dec. 13, 1960.

1001(a)'s computation of gain or loss. For example, in *Gray v. Franchise Tax Board*[55] the court queried:

> If a capital gains tax is not always a net income tax, the question then becomes whether it may be a net income tax under appropriate circumstances. Specifically, we must determine whether a capital gains tax is converted from a gross income tax to a net income tax where capital losses may be deducted from capital gains, where unused capital losses could be carried over for deduction to subsequent tax years, and where deductions are allowed for holding periods as well as certain personal exemptions. We conclude that it is.

The court in *Gray,* in concluding that the capital gains element of the Connecticut tax[56] was a net income tax, relied on the allowance for the taxpayer to apply unused capital losses from previous years to reduce the capital gain tax base that was otherwise subject to tax. The court concluded the Connecticut tax on capital gains was a net income tax eligible for the OSTC.

Imposition by and Payment to the Other State

The final determination for evaluating whether a tax is eligible for the OSTC is whether the tax is imposed by *and* paid to another state.[57] Thus, the OSTC is not available for taxes imposed by and/or collected by political subdivisions of another state, such as counties, cities, or other localities. Additionally, the OSTC is not available for taxes that are imposed by a city, county, or other locality, but collected by the state.

In determining whether a tax is imposed by and paid to another state, the mechanics of the tax must be analyzed without reference to the label applied to the tax. The United States Supreme Court in *Maryland v. Wynne*[58] held that although Maryland imposed a "so-called 'county' tax" upon its residents, the tax was actually a state tax imposed by and paid to the state of Maryland, "[d]espite the name[] that Maryland has assigned."[59] When a tax operates as a tax imposed by and/or collected by a county, city, or other locality, the tax is not imposed by and paid to the other state, so the OSTC is not available for payment of the tax. In contrast, if the tax is imposed by a state statute and paid to the state, the tax is deemed a tax imposed by and paid to the state, even if the tax is labeled a county, city, or other locality tax.

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[55] *Supra*, at 43.

[56] Conn. Gen. Stat., § 12-506.

[57] Rev. & Tax. Code, §§ 18001, subd. (a), 18002, subd. (a), and 18004.

[58] *Comptroller of the Treasury of Maryland v. Wynne* (2015) 135 U.S. 1787 (*Maryland v. Wynne*).

[59] *Id*., at 1791.

The payment of the tax must also be made through a transfer of property (usually cash) to the other state, not through the use of a tax credit generated by the taxpayer. A state tax credit, to the extent that it can only be applied against the credit generator's current or future state tax liability, is treated as a dollar-for-dollar reduction or potential reduction in the taxpayer's state tax liability, not as a payment of a state tax.[60] Thus, a taxpayer cannot receive the OSTC for other state taxes satisfied by a state tax credit generated by the taxpayer.

HOLDINGS[61]

SITUATION ONE

A is entitled to the OSTC in determining her California income tax liability based on the $2,500 of tax that she paid to Arizona on her pro rata share of Z's income. Pursuant to RTC section 18002, a nonresident of California may claim a California OSTC if his or her state of residence either does not tax income of California residents derived from sources within that state or allows California residents a credit against the taxes imposed by that state on income derived from sources within that state for net tax paid to California. Arizona provides a credit to California residents for tax paid to California on income sourced to Arizona, so it is a "reverse credit state," and an Arizona resident taxpayer is entitled to claim a California OSTC in determining taxes payable to California on California-source income. The payment of the Arizona tax meets the requirement under RTC section 18002 that the tax imposed by and paid to the other state be a net income tax because, as determined by California law, the tax was paid on A's pro rata share of Z's ordinary income from its trade or business, which was computed by deducting all allowable ordinary and necessary business expenses from total gross income. Because Arizona is a reverse credit state and the tax paid to Arizona on A's pro rata share of Z's income is a net income tax, the California OSTC is allowed.

SITUATION TWO

D is entitled to the OSTC in California only for the amount of the excise tax T paid to Tennessee, $6,500. Tennessee's taxing scheme for business entities is a combination of two independent taxes,[62] both of which are analyzed independently. D is entitled to the OSTC for the excise tax because it is measured by net earnings, which Tennessee defines as federal taxable income with some modifications. There is no component of cost of goods sold contained within the measure for the excise tax; thus, the excise tax is measured by

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[60] *Gray, supra*, at 40; Rev. Rul. 86-117, 1986-2 C.B. 157; IRS Chief Counsel Memo 201147024.

[61] Please note that for the purposes of the holdings in this legal ruling, the assumption is made that the California OSTC claimed by each of the taxpayers does not exceed the proportion set forth in Revenue and Taxation Code section 18001(a)(3) or 18002(a)(3). For this reason, the potential limitation of the credit by Revenue and Taxation Code section 18001(a)(3) and 18002(a)(3) is not addressed in any of the holdings in this legal ruling.

[62] See page 7 of the Tennessee Franchise and Excise Tax Guide, available online at https://tn.gov/assets/entities/revenue/attachments/feguide.pdf.

income. In contrast, the $1,000 franchise tax paid to Tennessee cannot be used for computing the California OSTC, because the franchise tax is not on, or according to, or measured by income.

SITUATION THREE

R may deduct on its California franchise tax returns for taxable years 1 and 2 the Texas franchise tax paid in those years when determining its California franchise tax liability, regardless of the specific components of its Texas franchise tax base. The Texas franchise tax is not a tax on, or according to, or measured by income, regardless of the manner in which the entity's taxable margin is determined. The Texas franchise tax is a single, indivisible tax, as a taxpayer can only be subject to paying one tax on one base in any year, regardless of the number of activities in which the business engages. This is true even though the taxpayer may compute multiple margins in order to comply with the requirement that the lesser margin be utilized as the base upon which the tax is computed. Thus, each computation method cannot be analyzed on its own, but rather, the tax as a whole must be analyzed to determine its character. Like the MSBT in the *Appeal of Dayton Hudson*[63] and the *Appeal of Kelly Services,*[64] the Texas franchise tax is a tax on many types of business activities, including manufacturers, merchandisers, miners, and service providers, so there is a potential for COGS to be included in the tax base. Although the Texas franchise tax offers several methods for computing the taxpayer's margin, not all of the methods remove COGS from the tax base, so the potential remains for COGS to be included in the tax base. Accordingly, the tax is not on, or according to, or measured by income so it is deductible by R on its California franchise tax return.

Q may not utilize the Texas franchise tax paid by R to Texas to calculate or claim a California OSTC against Q's California personal income tax liability in either year 1 or 2. The Texas franchise tax is not a gross or net income tax under general tax law, as total revenues from the taxpayers' entire businesses constitute the beginning margin and, as discussed above, the taxable base possesses the potential to include COGS. While a taxpayer's primary activities may yield one particular tax rate in any given year, a taxpayer's activities do not dictate what its taxable margin will be. Rather, all Texas franchise taxpayers must calculate and compare their respective margins under Texas Tax Code section 171.101 to determine their respective lowest taxable margin, which is apportioned and used as the measure of tax, which could result in a measure not constituting net or gross income for some taxpayers subject to the Texas franchise tax. The Texas franchise tax ultimately does not distinguish between the activities of a taxpayer when calculating the taxable margin, and the Texas franchise tax cannot be characterized as a gross or net income tax for the purposes of deduction or credit. However, Q will take into account her 12 percent pro rata share of R's Texas franchise tax and may claim it as a deduction, subject to any applicable limitations, such as passive activity, or at risk rules, against her California personal income tax liability in taxable years 1 and 2. The answers provided above are the same if the Texas entity utilizes its total revenue and the Texas EZ computation to determine its franchise tax liability.

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[63] *Appeal of Dayton Hudson*, *supra*.

[64] *Appeal of Kelly Services*, *supra*.

SITUATION FOUR

C is not entitled to a California OSTC based on its pro rata share of the MCTMT paid by X. The MCTMT is based on payroll expenses paid by the taxpayer; therefore, it is not "on, or according to, or measured by income" within the meaning of RTC section 18001(b). That is to say, the MCTMT is imposed on an expenditure, not an item of income realized by X, and thus, it is not imposed on an item that could be subject to a net income tax in either state. Moreover, although the New York State Tax Department administers the tax, the tax is imposed by and paid to the Metropolitan Transportation Authority. As such, the tax is not imposed by and paid to another state, as required by RTC section 18001.

SITUATION FIVE

B is not entitled to a California OSTC based on the LLET credit used to satisfy his Kentucky tax liability, as the LLET credit is not an amount "paid" to the other state. The LLET credit is a nonrefundable tax credit. It is not a payment of tax. Nonrefundable tax credits are part of the overall calculation to arrive at the amount of net tax shown on a return, and not part of the satisfaction or payment of the net tax after it is calculated.

Additionally, B is not entitled to compute the OSTC using his pro rata share of taxes paid to Kentucky by Y, as if those taxes had been paid by the member of the LLC taxed as a partnership, because the other state tax is the LLET, which is not a net income tax. The LLET is a single, indivisible tax, in which the taxpayer only pays one tax rate on one base. However, various taxpayers subject to the Kentucky LLET could be paying the LLET on amounts that, for some, are not based on income (i.e. gross receipts), and therefore the LLET is a tax not on, or according to, or measured by income.

Further, B cannot deduct on his California income tax return his proportionate share of the Kentucky LLET credit used to fully satisfy his personal income tax liability owed to Kentucky, as it was not an income tax paid to the other state.

SITUATION SIX

P is entitled to a California OSTC for the amount of the tax paid to New York on the gain on the sale of its interest in M. Pursuant to RTC section 18003, because it is subject to tax in both states, P is a trust that is a resident of both New York and California. Because P is a resident of California and another state, the trust is eligible for the OSTC under RTC section 18004. For purposes of the OSTC for dual resident trusts under Section 18004, the OSTC is allowed regardless of the source of the income. As such, the trust is eligible[65] for the OSTC computed on the full amount of the tax paid to New York on the sale of its interest in M.

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[65] Note that the OSTC would not be allowed if the taxpayer claiming the OSTC in Situation Six were an individual resident of California, as opposed to a dual state resident trust, because the code section that grants the OSTC to an individual California resident taxpayer, RTC section 18001(c), requires that California's sourcing laws source the double taxed income to the other state. The code section granting the OSTC to a dual state resident trust, RTC section 18004, does not contain this sourcing limitation; thus, unlike an individual California

EFFECTIVE DATE

This ruling will be applied for taxable years beginning on or after January 1, 2016.

DRAFTING INFORMATION

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resident taxpayer, the dual state resident trust can receive the OSTC when California law sources the double taxed income to California.