



Analysis of Original Bill

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Sponsor:

Bill Number: AB 978

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Related Bills: See Legislative
History

Subject: Other State Tax Credit

Summary

This bill, under the Personal Income Tax Law (PITL), would modify the rules used by California residents for determining the other state tax credit (OSTC).

Recommendation – No position.

Reason for the Bill

The reason for this bill is to ensure that taxpayers could use the amount of income taxes paid to other states as a credit against taxes owed in California.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment, and would be operative for taxable years beginning on or after January 1, 2019.

Program Background

Residents of California are taxed on all income, including income from sources outside California.

In some instances, taxpayers are taxed by both California and another state on the same net income. To prevent the income from being taxed twice, either California or the other state will generally allow a credit to offset the taxes paid to the other state.

California residents may claim a credit for net income taxes imposed by and paid to another state only on income which has a source within the other state. No credit is allowed if the other state allows California residents a credit for net income taxes paid to California.

For purposes of calculating the OSTC, California's sourcing principles apply even though the results may be contrary to the other states' principles. The following describes the sourcing principles for various types of income:

- Compensation for services rendered by employees or independent contractors has a source where the services are performed.
- Income from tangible personal property and real estate has a source where the property is located.
- Income from intangible personal property (such as interest and dividends) generally has a source where the owner resides.
- Business income has a source where the business is conducted.

Federal/State Law

There is no federal credit comparable to the OSTC discussed in this bill.

Existing state law imposes a tax on the income earned by individuals, partnerships, estates, and trusts. Tax is imposed on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California.

Existing California law allows a tax credit for net income taxes paid to a state other than California. The credit is based on net income taxes paid to the other state on income that has a source in the other state, and is also taxable under California law.

California statutes, regulations and case law are used to determine the source of income, regardless of any provision or interpretation of the law of the other state.

California case law provides precedential guidance on determining whether another state's tax is a tax on net income. Factors in making that determination may vary based on whether the other state's tax is a single indivisible tax or is a tax that is an aggregation of several separate taxes.

In situations where the other state's tax is a single, indivisible tax, the tax base as a whole is analyzed to determine whether the tax is a tax on net income. This applies even when a state's single, indivisible tax may be calculated using one of several alternative methods. In contrast, in situations where the other state's tax is an aggregation of several separate taxes, each of the separate taxes is analyzed independently to determine whether it is a tax on net income. In both situations the characterization of the other state's tax is universal for all taxpayers, rather than being determined on a per taxpayer basis.

California law¹ currently allows a deduction for taxes other than an income tax, paid by a taxpayer during the taxable year. Thus, a tax that is excluded from the computation of the OSTC may be deductible.

This Bill

This bill, under the PITL, would modify the determination of whether another state's tax is a tax on net income for purposes of the OSTC, by specifying that the actual method used by a taxpayer to calculate the tax they paid to another state without regard to the method used by other taxpayers would be controlling.

Implementation Considerations

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill uses phrases that are undefined, i.e., "actual method used," and "method used by other taxpayers." The absence of definitions to clarify these phrases could lead to disputes with taxpayers and would complicate the administration of this bill. For example, the phrase "actual method used" would potentially allow a method that is neither allowed nor required by another state. The author may want to amend the bill to clearly define the phrases.

This bill would create a new standard for the definition of a net income tax that would be in conflict with numerous federal and California courts' decisions² and prior Board of Equalization decisions that define net income tax. Thus resulting in conflicting authority between the Revenue and Taxation Code and controlling income tax decisions.

To clarify the operative date, it is recommended that the bill be amended to specify that the proposed change would apply to taxable years beginning on or after January 1, 2019.

¹ See CTL section 24345.

² See *Beamer v. Franchise Tax Board* (1977) 19 Cal. App. 3d 475. *MCA, Inc. v. Franchise Tax Board* (1981) 115 Cal. App. 3d 185. *Robinson v. Franchise Tax Board* (1981) 120 Cal. App. 3d 72.

Legislative History

AB 2771 (Irwin, 2015/2016) would have, under the PITL, modified the sourcing rules required to be used by California residents when calculating the OSTC. AB 2771 failed to pass by the constitutional deadline.

SB 1449 (Nguyen, 2015/2016) would have modified the sourcing rules in determining income derived from sources within another state. SB 1449 failed to pass by the constitutional deadline.

AB 2979 (Assembly Revenue and Taxation Committee, Chapter 374, Statutes of 2002) among other things, codified the detailed rules regarding sourcing of out-of-state income that were in both case law and regulations.

Other States' Information

The states surveyed include *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's income tax laws.

Illinois allows a credit equal to the lesser of the tax on items of income included in both states or the amount of the *Illinois* tax multiplied by the gross income taxable in the other state divided by the total gross income for *Illinois*.

Massachusetts allows a credit equal to the lesser of tax due to the other state reduced by interest, penalties, and any federal credit allowable on the federal return, or the amount of the *Massachusetts* tax multiplied by the gross income taxable in the other state divided by the total gross income for *Massachusetts*.

New York allows a credit for taxes paid to other states. The credit cannot reduce the tax below the amount of tax that would have been due had the income from the other state not been included.

Minnesota allows a credit equal to the lesser of the *Minnesota* tax on income taxed by the other state (compared in proportion to adjusted gross income (AGI)) or the tax imposed by the other state on that income.

Michigan allows a credit for taxes paid to other states and Canadian provinces on income that is included in Michigan AGI. The credit is equal to the lesser of the amount of tax imposed by the other jurisdiction, or the amount of Michigan tax on income earned in the other jurisdiction.

Fiscal Impact

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified.

Economic Impact

Revenue Estimate

There would be a revenue impact to the general fund, but the amount is unknown.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Due to the lack of available data, it is difficult to predict the frequency and amount of credits that would be impacted by this bill. Therefore, we cannot provide an annual estimate. However, based on a three-year average for the OSTC, the department estimates that for every one percent of taxpayers impacted there would be a revenue loss of approximately \$10 million.

Policy Concerns

This bill would result in a departure from longstanding case law precedent that applies California income tax principles as opposed to the other state's characterization of a tax for determining whether a tax paid to another state is a tax based on net income for purposes of California's OSTC.

This bill would create a statutory difference between the OSTC and the deduction for taxes as to what is an income tax. This may cause disparate treatment between taxpayers upon payment of the same tax. Because this bill would change the statutory and judicial determination of an income tax, it would allow for advantageous tax planning opportunities separate from the realities of what the tax actually is.

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