

**INITIAL STATEMENT OF REASONS FOR THE AMENDMENT OF CALIFORNIA  
CODE OF REGULATIONS, TITLE 18, SECTION 18001-1**

**PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR  
CIRCUMSTANCE THAT THE REGULATORY ACTION IS INTENDED TO ADDRESS**

California Revenue and Taxation Code (RTC) Section 18001 allows a credit against the net tax for net income taxes imposed by and paid to another state on specified income. Under RTC section 18001, the payment of tax to another state is generally eligible for the Other State Tax Credit (OSTC) only where the other state's tax is a net income tax. The tax that is imposed on items other than net income would not be considered a net income tax for purposes of the OSTC. Some taxpayers are incorrectly analyzing the term "net income tax" because of uncertainty in the law, which in turn results in taxpayers incorrectly claiming an OSTC.

The intent of the proposed amendments to Title 18 of the California Code of Regulations (CCR) section 18001-1 (Proposed Regulatory Action) is to provide clarity to taxpayers, tax practitioners, and the State of California with regards to "net income tax" for purposes of the OSTC. The Proposed Regulatory Action provides appropriate criteria and guidance on implementing the OSTC as provided in RTC section 18001 and confirms the Franchise Tax Board's (Board) long-standing administration of RTC section 18001.

**SPECIFIC PURPOSE OF THE REGULATORY ACTION**

The Proposed Regulatory Action would clarify the term "net income tax" for purposes of RTC section 18001 and would create new subsections at (a)(1) and (a)(2) as described more fully, below. Specifically, the Proposed Regulatory Action would provide that a tax is only considered a net income tax for purposes of the OSTC where the tax is imposed on only net income. A tax that is imposed on items other than net income, as applied to all taxpayers, is not a net income tax.

**NECESSITY**

The first proposed amendment in the Proposed Regulatory Action adds a new numbered subsection to the existing regulatory text at subsection (a), renumbering it as (a)(1). This proposed amendment is necessary to organize the regulation and keep the existing text clearly delineated for taxpayers in light of the proposed additional text as described immediately below. Without the creation of new subsection (a)(1) taxpayers might be challenged to follow a lengthy regulatory provision without clear organization.

The second proposed amendment in the Proposed Regulatory Action creates new subsection (a)(2), to clarify the term "net income tax" for purposes of RTC section 18001. The determination of whether the OSTC is permitted turns on whether a tax is a tax on net income. If a tax is a tax on net income, the taxpayer may qualify to claim the OSTC if the net income tax was imposed by and paid to the other state. In order to decide the character of the tax, the entire statutory methodology of the other state tax structure must be examined to determine whether the tax is a net income tax. The second proposed amendment to the Proposed Regulatory Action is necessary to clarify how to determine whether a tax is a net income tax. Some states have enacted multi-faceted tax systems which combine components of a gross receipts tax, a gross income tax, and a net income tax. As the OSTC is only eligible for taxes on net income, there is a necessity to clarify the term of a "net income tax". Without this proposed amendment the definition of a tax on net income is less clear and may cause confusion for taxpayers.

## **BENEFITS ANTICIPATED FROM THE REGULATORY ACTION**

The Proposed Regulatory Action will benefit taxpayers, tax practitioners, and the State of California by providing clarity that taxpayers and tax practitioners may not have. It will provide procedural guidance for the consistent application of the OSTC. The Proposed Regulatory Action will clarify which taxes are considered a "net income tax." The clarity from the Proposed Regulatory Action will reduce uncertainty for taxpayers and tax practitioners, and will facilitate tax administration for the State of California by providing a clear rule defining net income taxes. These benefits are the result of goals developed by the Board with input from interested parties and based on broad statutory authority.

## **TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS OR DOCUMENTS**

In drafting the Proposed Regulatory Action, the Board primarily relied on RTC section 18001, relevant case law, and Legal Ruling 2017-01. The FTB also relied on suggestions from the members of the public obtained throughout the course of two interested parties meetings (IPM). The Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the revisions to the regulation.

## **ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESSES**

In accordance with Government Code section 11346.2, subdivision (b)(5), that requires the Board to consider alternatives to the Proposed Regulatory Action, Board staff conducted two IPMs. A preliminary IPM was held on August 7, 2019, to solicit input from

the public. Staff discussed with attendees the potential for a regulation project to clarify the OSTC. A summary of the first IPM was thereafter made available to the public.

A second IPM was held on July 30, 2020, at which staff provided proposed language. As noted above, the purpose of the meeting was to provide participants with an opportunity to discuss and provide comments on the proposed language of the Proposed Regulatory Action. In addition, the Explanation of Draft Text was also made available to the public. The summary of the second IPM was thereafter made available to the public. After the second IPM, staff did not receive any comments from the public regarding the Proposed Regulatory Action language.

The alternative to adopting the Proposed Regulatory Action is the status quo, which would not provide taxpayers improved guidance on what qualifies as a "net income tax." The status quo may confuse taxpayers and create the risk of taxpayers incorrectly claiming an OSTC.

Accordingly, the Board has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the Proposed Regulatory Action, or would be less burdensome with respect to affected private persons or small businesses than the Proposed Regulatory Action.

## **ECONOMIC IMPACT ASSESSMENT**

### Creation or Elimination of Jobs within the State

The Proposed Regulatory Action will not impact employment in California—jobs will neither be created nor eliminated due to this regulation. This is due to the fact that the Proposed Regulatory Action would merely provide clarity on the term "net income tax." By further defining "net income tax," the Proposed Regulatory Action clarifies the type of tax paid by California taxpayers on out of state income that qualifies for an OSTC. The increased certainty from the Proposed Regulatory Action will result in fewer errors in the future and eliminate taxpayer confusion on this issue. Because it does not impact the taxation of business activity within California, the Board does not anticipate any impact on employment in California.

### Creation of New or Elimination of Existing Businesses within the State

The Proposed Regulatory Action will not impact the creation of new businesses or cause the elimination of existing businesses in California. This is due to the fact that the Proposed Regulatory Action would merely provide clarity on the term "net income tax." By further defining "net income tax," the Proposed Regulatory Action clarifies the type of tax paid by California taxpayers on out-of-state income that qualifies for an OSTC. The increased certainty from the Proposed Regulatory Action will result in fewer errors in the

future and eliminate taxpayer confusion on this issue. The clarification provided would neither result in new business creation or elimination of existing businesses because economic decisions and business investments would not be affected. Therefore, the Proposed Regulatory Action would not provide an incentive for the creation of new businesses within the state or the elimination of existing ones.

#### Expansion of Businesses Currently Doing Business within the State

The Proposed Regulatory Action is intended to provide clarity to existing law for taxpayers, tax practitioners, and the state regarding the term "net income tax." The Proposed Regulatory Action would not impact the business climate in the state, and therefore, it would not result in the expansion of businesses doing business in California. This is because the goal of this regulatory action is to provide information to ensure any questions regarding the term "net income tax" are clearly addressed, and the likelihood of non-qualifying taxes receiving the OSTC is minimized.

#### Benefits to the Health and Welfare of California Residents, Worker Safety, and the State's Environment

The Proposed Regulatory Action is intended to provide clarity to the type of tax on out-of-state business activity of businesses owned by California taxpayers that qualifies for an OSTC. The Board does not anticipate any impact on the health and welfare of California residents, or work safety, or the state's environment.

### **ADVERSE ECONOMIC IMPACT ON BUSINESSES**

The Board has determined that the Proposed Regulatory Action will not have a significant economic impact on businesses. The Proposed Regulatory Action clarifies the type of tax paid by California taxpayers on out-of-state income that qualifies for the OSTC. The Board has determined that there would be no impact on the taxation of business activity in California, and therefore FTB does not anticipate any adverse economic impacts on businesses in California.