



MULTISTATE INCOME/FRANCHISE TAX

## Taxpayers consenting to inclusion in California's pass-through entity tax may have a reduced other state tax credit due to calculation mechanics

### Tax Alert

## Overview

California allows a credit for taxes paid to other states based on a ratio of double taxed income over total California income times an individual's California net tax (as defined by section [17039](#)) payable. Based on the mechanics of [California Schedule S](#), the Franchise Tax Board ("FTB") interprets the term "net tax payable" to be tax after most credits are utilized including the California Passthrough Entity Tax credit ("CA PET"). Under this interpretation, taxpayers with CA PET credits may see a reduction in their other state tax credit ("OSTC") because the CA PET may reduce "net tax payable" which may reduce the federal benefit of consenting to inclusion in California's pass-through entity tax regime.

## California Schedule S - Other State Tax Credit

California residents must use California Schedule S to compute their allowable OSTC. The mechanics of Schedule S use the following mathematical equation:

$$\frac{\text{Double taxed income}}{\text{California AGI}} \times \text{"California tax liability"} = \text{OSTC}$$

"California tax liability" is defined in the instructions to Schedule S as [California Resident Income Tax Return - Form 540](#), Line 48 without reduction for OSTC. Form 540, Line 48 reflects tax liability after credits (other than a few exceptions such as earned income tax credit and young child tax credit). As a result, the tax base upon which OSTC is calculated is reduced by any CA PET credit a taxpayer has.

## California Revenue and Taxation Code sections 17039, 18001, and 18006

California Revenue and Taxation Code (“CRTC”) section [18001](#) provides the statutory authority for calculating allowable OSTC. Specifically, CRTC section 18001(a)(3) states:

The credit shall not exceed the proportion of the “net tax” (as defined by Section 17039) payable under this part as the income subject to tax in the other state (not including any preference, alternative, or minimum tax comparable to the tax imposed by Section 17062) and also taxable under this part bears to the taxpayer’s entire income upon which the “net tax” (as defined by Section 17039) is imposed by this part.

Mathematically, this translates into:

$$\frac{\text{Double taxed income}}{\text{California AGI}} \times \text{net tax payable} = \text{OSTC}$$

CRTC section 18001(a)(3) specifically provides that “net tax” is defined by section 17039. The only credits included in CRTC section [17039](#)’s definition of “net tax” are personal exemptions.

In its [June 2022 Tax News](#) the FTB explained that tax credits reduce the amount payable by the taxpayer. Therefore, the net tax payable is after credits. FTB further stated that based on prior legal rulings (see [Letter Ruling 2017-01](#)) and case law (see [Gray v. Franchise Tax Board \(1991\) 235 Cal.App.3rd 36](#)), a credit that is only creditable against current year and future years tax liability, is not considered paid to the state.

CRTC section [18006\(a\)](#) states:

A member of a partnership is allowed to treat his, her or its pro rata share of net income taxes paid to another state by the partnership as if those taxes had been paid directly by the partner.

If the CA PET is treated the same as other state PETs, then the partner’s share of the CA PET is a tax paid by the partner.

### Takeaway

Under the FTB’s current interpretation of the OSTC calculation, California residents consenting into inclusion in the CA PET regime may see their OSTC reduced by the CA PET credit. In certain circumstances, this could reduce some or all of the taxpayer’s federal benefit from consenting to inclusion in the CA PET. It is recommended that taxpayers discuss their particular facts and circumstances with their tax advisor to determine whether this will impact their overall federal benefit of inclusion in California’s PET.

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