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## **SUPERSEDED BY FTB NOTICE 2010-2**

### **FTB NOTICE 2009-06**

**Subject:** California Treatment of the Revised Texas Franchise Tax for Purposes of Determining Eligibility for an Other State Tax Credit or a Deduction for California Income and Franchise Tax Purposes.

#### **PURPOSE**

Guidance has been requested as to the general eligibility for the Other State Tax Credit (OSTC) and deductibility of the Revised Texas Franchise Tax (also known as the Texas Margin Tax and hereinafter "RTFT").<sup>1</sup> However, the determination of whether a taxpayer is eligible for an OSTC or a deduction of the RTFT is highly fact-specific and must be made on a case-by-case basis. This Notice is being issued as general guidance for taxpayers. As such, this Notice describes the mechanics of the RTFT and sets forth the relevant California case law and rules that taxpayers must analyze in light of their individual circumstances in order to determine whether the RTFT is a gross receipts tax, a gross income tax, or a net income tax. Taxpayers' characterization of the RTFT based on their circumstances will determine whether the RTFT will be eligible for the OSTC or deductible for California income and franchise tax purposes. Finally, after making that determination, a taxpayer may use the chart provided in Attachment 1.

#### **REVISED TEXAS FRANCHISE TAX**

For Texas Franchise Tax Reports due on or after January 1, 2008, taxpayers are now subject to the RTFT.<sup>2</sup> The RTFT is calculated in one of two ways: (1) the general RTFT method (Methods 1-3), and (2) the E-Z Computation (Method 4) for taxpayers with \$10 million or less in "total revenue."<sup>3</sup>

<sup>1</sup> Texas Tax Code (Tex. Tax Code), Title 2, Subtitle F, Chapter 171, §§ 171.0001 et seq. All references to the Tex. Tax Code are subject to change for the applicable law for the taxable year at issue; please see the current version of the Tex. Tax Code. Many commentators also refer to the RTFT as the Texas Margin Tax.

<sup>2</sup> Texas Administrative Code, Title 34, Part 1, Ch. 3, Sub. V, Rule 3.581 et. seq.

<sup>3</sup> For all methods, if the taxpayer's total revenue is less than \$900,000.00 but greater than \$300,000.00, the RTFT owed is reduced by a discount. (Tex. Tax Code, § 171.0021.) If the taxpayer's "annualized total revenue" is less than \$300,000.00 or if the computed RTFT is less than \$1,000.00, the taxpayer does not owe the RTFT. (Tex. Tax Code, § 171.002(d).) This rule does not apply if the entity is a tiered partnership. For Texas Franchise Tax Reports due after January 1, 2010, the State of Texas House Bill No. 4765 amended Tex. Tax Code, § 171.002(d), if the taxpayer's "annualized total revenue" is less than \$1,000,000.00, or if the computed RTFT is less than \$1,000.00, the taxpayer does not owe the RTFT.

For this purpose, "total revenue" is defined by Texas statute.<sup>4</sup> To calculate "total revenue", the taxpayer adds its gross receipts or sales, less returns and allowances, plus additional income, and **subtracts** items including, but not limited to, bad debt expense, foreign royalties and dividends, and Schedule C dividends and income from a related entity. Several of these items may only be subtracted to the extent the amounts were included in gross revenue.

The General RTFT Method. First, the taxpayer calculates its RTFT by determining its "margin" using the three methods<sup>5</sup> described below:

**Method 1:** Margin equals total revenue multiplied by 70 percent.<sup>6</sup>

**Method 2:** Margin equals total revenue minus the sum of cost of goods sold (as defined by Texas law).<sup>7</sup>

**Method 3:** Margin equals total revenue minus the sum of compensation (as defined by Texas law).<sup>8</sup>

Once the three margins are calculated, the taxpayer multiplies the lowest of the three amounts by an apportionment factor, where applicable. From this result, the taxpayer subtracts any allowed deductions, thus determining the "taxable margin." Next, the taxpayer multiplies the "taxable margin" by the appropriate tax rate, determining the "tax due." Finally, the taxpayer arrives at the "total tax due" by applying any tax credits and discounts.

The E-Z Computation Method. **Method 4:** As an alternative to using one of the general RTFT methods described above, a taxpayer with total revenue of \$10 million or less could elect to apply the E-Z Computation, or Method 4.<sup>9</sup> The taxpayer calculates the "tax due before discount" by applying a rate of 0.575 percent to the product of the taxpayer's "total revenue" multiplied by an apportionment factor, where applicable. Finally, the taxpayer reduces the result by applicable discounts, arriving at the "total tax due" under the E-Z Computation method.<sup>10</sup>

## CALIFORNIA CASE LAW ANALYSIS

The proper characterization of a tax is determined by its operation, not its labels.<sup>11</sup> A tax is analyzed by applying general tax law, including applicable federal and California

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<sup>4</sup> Tex. Tax Code, § 171.1011(c).

<sup>5</sup> Tex. Tax Code, § 171.101.

<sup>6</sup> Tex. Tax Code, § 171.101(a)(1)(A).

<sup>7</sup> Tex. Tax Code, §§ 171.101(a)(1)(B)(ii)(a), (iii).

<sup>8</sup> Tex. Tax Code, §§ 171.101(a)(1)(B)(ii)(b), (iii).

<sup>9</sup> Tex. Tax Code, § 171.1016.

<sup>10</sup> Tex. Tax Code, §§ 171.1016(d), 171.0021.

<sup>11</sup> *Beamer v. Franchise Tax Board* (1977) 19 Cal.3d 467, 475 [138 Cal.Rptr. 199, 203; 563 P.2d 238, 242].

authorities.<sup>12</sup> Furthermore, any analysis is "required to measure the tax by reference to the specific income activity taxed" on a case by case basis.<sup>13</sup> Thus, each method available under the RTFT must be analyzed separately for purposes of determining eligibility for a California OSTC or whether such amount would be deductible for California income and franchise tax purposes.

A tax may, in whole or in part, be a gross receipts tax, a gross income tax, or a net income tax.<sup>14</sup> A *gross receipts tax* is a tax imposed on gross income and a return of capital, which includes cost of goods sold.<sup>15</sup> A *gross income tax* is a tax imposed on gross income only, with any return of capital, such as cost of goods sold, excluded from the tax base.<sup>16</sup> A *net income tax* is a tax imposed on the income that remains after gross income is reduced by deductions, credits, or exemptions.<sup>17</sup>

As of the date of this Notice, no California court has reviewed the RTFT. The characterization of this tax is dependent on the method used to calculate it and the type of income subject to the RTFT.

### **OSTC Rules**

Assuming specific California statutory requirements are satisfied, California allows an OSTC to alleviate double taxation.<sup>18</sup> Tax credits are "strictly matters of legislative grace and are to be construed against the taxpayer."<sup>19</sup> In order for a California resident to claim an OSTC, the income subject to double taxation must be sourced to the other state pursuant to California sourcing rules.<sup>20</sup> In order for a California nonresident to claim an OSTC, the income subject to double taxation must be sourced to California pursuant to California sourcing rules.<sup>21</sup>

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<sup>12</sup>*Ibid.*; *MCA, Inc. v. Franchise Tax Board* (1981) 115 Cal.App.3d 185 [171 Cal.Rptr. 242]; *Robinson v. Franchise Tax Board* (1981) 120 Cal.App.3d 72 [174 Cal.Rptr. 437]; *Gray v. Franchise Tax Board* (1991) 235 Cal.App.3d 36 [286 Cal.Rptr. 453].

<sup>13</sup> *Robinson, supra*, 120 Cal.App.3d at pp. 80-81.

<sup>14</sup> *Gray, supra*, 235 Cal.App.3d at p. 44.

<sup>15</sup> *Robinson, supra*, 120 Cal.App.3d at p. 78.

<sup>16</sup> *MCA, supra*, 115 Cal.App.3d 185 at p. 192; *Gray, supra*, 235 Cal.App.3d at pp. 42-43; Int.Rev. Code, § 61; Rev. & Tax Code, § 17071.

<sup>17</sup> *Gray, supra*, 235 Cal.App.3d at pp. 41-42.

<sup>18</sup> See Rev. & Tax Code, §§ 18001-18011; Cal. Code of Regs., tit. 18, §§ 18001-1, 18001-2; and FTB Schedule S.

<sup>19</sup> *Christman v. Franchise Tax Board* (1976) 64 Cal.App. 3d 751, 757 [134 Cal.Rptr. 725, 729].

<sup>20</sup> Rev. & Tax Code, § 18001, subd. (c); Rev. & Tax Code, §§ 17951-17955; Cal. Code of Regs., §§ 17951-1 et seq. See *Christman, supra*, 64 Cal.App. 3d 751 at p. 759.

<sup>21</sup> *Gray, supra*, 235 Cal.App.3d at p. 40. California may only tax California source income of a nonresident. See Rev. & Tax Code, §§ 17951-17955 and Cal. Code of Regs., tit. 18, §§ 17951-1 et seq.

***OSTC for a California resident:*** An OSTC is available 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.<sup>22</sup>

***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.<sup>23</sup> However, an OSTC is not allowed for taxes paid to a state which allows its residents an OSTC for net tax paid to California irrespective of whether its residents are allowed a California OSTC.<sup>24</sup>

***OSTC for a California resident or nonresident S corporation shareholder:*** An OSTC is available for the taxpayer's pro rata share of any taxes paid by an S corporation to the other state that imposed the tax on, according to, or measured by an S corporation's income or profits, paid or accrued.<sup>25</sup> Therefore, this OSTC is available for taxes paid to the other state on gross income or net income, not gross receipts. 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 to be treated as an S corporation in the other state.<sup>26</sup>

Texas allows a corporation to make an election to be treated as an S corporation. Therefore, to claim the OSTC for the RTFT, the taxpayer must be a shareholder of an S corporation that elected S corporation treatment in Texas.

***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.<sup>27</sup>

***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.<sup>28</sup>

***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

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<sup>22</sup> Rev. & Tax Code, §§ 18001, subd. (a) and (c).

<sup>23</sup> Rev. & Tax Code, §§ 18001, subd. (a)(1).

<sup>24</sup> Rev. & Tax Code, §§ 18002, subd. (a)(2).

<sup>25</sup> Rev. & Tax Code, §§ 18001, 18006, subd. (b). The underlined language excludes a gross receipts tax. See *Beamer, supra*, 19 Cal.3d 467 at p. 479.

<sup>26</sup> Rev. & Tax Code, §§ 18006(b)(2)(A) and (B).

<sup>27</sup> Rev. & Tax Code, §§ 18001(a), 18006(a).

<sup>28</sup> Rev. & Tax Code, § 18004.

trust to another state, assuming the beneficiary is taxable on income of the estate or trust under California Revenue and Taxation Code sections 17731–17779.<sup>29</sup>

### **Deduction Rules**

An individual cannot deduct gross income or net income taxes paid to another state.<sup>30</sup> A deduction is available if the individual paid a gross receipts tax to another state in connection with carrying on a trade or business.

An entity taxed as a partnership cannot deduct gross income or net income taxes paid to another state.<sup>31</sup> A deduction is available for a gross receipts tax paid to another state.

An entity taxed as a corporation cannot deduct gross income or net income taxes that are paid to another state.<sup>32</sup> A deduction is available for a gross receipts tax paid to another state.

### **CONCLUSION**

Due to the different types of taxpayers subject to the RTFT and the various types of "total revenue" (as defined by Texas law) subject to this tax, FTB cannot provide a definitive characterization of the different methods of the RTFT that applies to each and every taxpayer.<sup>33</sup> A taxpayer seeking to claim a California OSTC or a deduction for California income and franchise tax purposes, due to payment of the RTFT, should first characterize the RTFT based on the taxpayer's specific facts and circumstances as either a gross receipts tax, a gross income tax, or a net income tax. Then a taxpayer may review Attachment 1 for assistance in determining availability of an OSTC or deduction. Please note this Notice does not address all of the statutory requirements of the California Revenue and Taxation Code and California Code of Regulations that must be satisfied for a taxpayer to be entitled to claim a California OSTC or a deduction for California income or franchise tax purposes.

If a taxpayer claimed a California OSTC for the RTFT and the tax is ultimately credited or refunded by the State of Texas to the taxpayer, the taxpayer must notify the FTB.<sup>34</sup> Upon

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<sup>29</sup> Rev. & Tax Code, § 18005.

<sup>30</sup> Rev. & Tax Code, §§ 17201, 17220(a); Int.Rev. Code, §164(a); *Beamer, supra*, 19 Cal.3d 467 at pp. 479-480.

<sup>31</sup> Rev. & Tax Code, §§ 17201, 17220, and 17853.

<sup>32</sup> Rev. & Tax Code, § 24345(b).

<sup>33</sup> 2009 Texas Franchise Tax Report Information and Instructions (Form 05-393, p. 1): Certain taxpayers are exempt from the RTFT, including, but not limited to: sole proprietorships (except single member LLCs); general partnerships where direct ownership is entirely composed of natural persons (except LLPs); certain unincorporated passive entities; certain grantor trusts; estates of natural persons and escrows; and real estate mortgage investment conduits (REMICs) and certain real estate investment trusts (REITs).

<sup>34</sup> Rev. & Tax Code, § 18007.

notice and demand from the FTB, the taxpayer owes California tax equal to the California OSTC allowed for taxes subsequently credited or refunded by the State of Texas.<sup>35</sup>

#### **DRAFTING INFORMATION**

The principal author of this notice is Jeanne M. Sibert of the Franchise Tax Board, Legal Division. For further information regarding this notice, contact Ms. Sibert at Legal Division MS A260, Franchise Tax Board, P.O. Box 1720, Rancho Cordova, CA 95741-1720.

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<sup>35</sup> Rev. & Tax Code, § 18008.

**Attachment 1**

<b>Other State Tax Credit and Deduction Chart for the Revised Texas Franchise Tax<sup>36</sup></b>			
	Type of Tax Paid to Other State		
	Gross Receipts Tax	Gross Income Tax	Net Income Tax
<b>Other State Tax Credit</b>			
Resident [§ 18001(a)] Nonresident [§ 18002(a)]	No OSTC	No OSTC	Yes OSTC
Resident S corporation shareholder [§§ 18001(b), 18006(b)] Nonresident S corporation shareholder [§§ 18002(b), 18006(b)]	No OSTC	Yes OSTC	Yes OSTC
Resident partner of partnership, or member of an LLC (taxed as a partnership), [§§ 18001(a), 18006(a)] Nonresident partner of partnership, or member of an LLC (taxed as a partnership), [§§ 18002(a), 18006(a)]	No OSTC	No OSTC	Yes OSTC
Resident estate or trust that is also a resident of another state [§ 18004]	No OSTC	No OSTC	Yes OSTC
Resident beneficiary of estate or trust [§ 18005]	No OSTC	No OSTC	Yes OSTC
<b>Deduction</b>			
Individual (tax paid in connection with trade or business), [§§ 17201, 17220]	Yes Deduction	No Deduction	No Deduction
Partnership or LLC taxed as partnership [§§ 17201, 17220, 17853]	Yes Deduction	No Deduction	No Deduction
Corporation or S corporation [§ 24345]	Yes Deduction	No Deduction	No Deduction

<sup>36</sup> This chart only provides a summary of which type of tax is eligible for a California OSTC or a deduction for California income or franchise tax purposes. However, as described in this Notice, a taxpayer must first characterize the RTFT based on the taxpayer's specific facts and circumstances as either a gross receipts tax, a gross income tax, or a net income tax. Then a taxpayer may review this chart for assistance in determining the availability of an OSTC or deduction for California franchise and income tax purposes.