

**CALIFORNIA LAWYERS ASSOCIATION  
TAXATION SECTION  
2019 SACRAMENTO DELEGATION PAPER**

**UPDATING CALIFORNIA'S OTHER STATE TAX CREDIT LAWS  
TO ACCOUNT FOR NEW PASS-THROUGH ENTITY TAX  
REGIMES RECENTLY ENACTED IN OTHER STATES IN  
RESPONSE TO THE TAX CUTS AND JOBS ACT OF 2017<sup>1,2,3</sup>**

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<sup>2</sup> Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this paper. No author has a direct personal or financial interest in the issue addressed in this paper.

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## EXECUTIVE SUMMARY

Like most states imposing a personal net income tax on individual residents, subject to certain limitations, California allows a credit against California's personal income tax for net income taxes paid to another state on income derived from sources within the other state. Under California law, this other state tax credit ("OSTC") has traditionally been allowed for both net income taxes directly paid to another state by a California resident,<sup>4</sup> and on a California resident's pro-rata share of net income taxes paid to another state by a partnership.<sup>5</sup> Under Cal. Rev. and Tax. Code ("CRTC") Section 18001, "net income taxes" that can qualify for the OSTC also includes amounts "paid by an S corporation, as provided under [CRTC] Section 18006."<sup>6</sup> Under CRTC Section 18006, net income taxes paid by an S corporation can be treated as directly paid by the S corporation's shareholders for OSTC purposes if either: (1) the state imposing the tax does not allow corporations to elect to be treated as an S corporation (*i.e.*, they are required to file as a C corporation); or (2) the state imposes a tax on S corporations and the corporation at issue has elected S corporation status in that state.<sup>7</sup>

In response to the Tax Cuts and Jobs Act of 2017 ("TCJA") limiting the federal deduction for state and local taxes to \$10,000 for individuals (\$5,000 if married filing separately),<sup>8</sup> several states have enacted new pass-through entity tax regimes attempting to preserve the federal deductibility of state taxes. Generally, these entity level taxes are intended to shift the tax burden to business entities that are not subject to the TCJA's \$10,000 annual limitation, which only applies to individuals. As of the date of this discussion paper, five states have enacted new pass-through entity tax regimes in response to the TCJA (Connecticut, Wisconsin, Oklahoma, Louisiana, and Rhode Island). All of these new pass-through entity tax regimes except for Connecticut are elective in nature. As a related matter, pass-through entity tax bills have been proposed, but not enacted, in Arkansas, Michigan, Minnesota, and New Jersey. This proposal is not intended to and does not address whether

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<sup>4</sup> CAL. REV. & TAX. CODE § 18001.

<sup>5</sup> CAL. REV. & TAX. CODE § 18006.

<sup>6</sup> CAL. REV. & TAX. CODE § 18001(b).

<sup>7</sup> CAL. REV. & TAX. CODE § 18006(b).

<sup>8</sup> See IRC Section 164(b)(6) as applicable for tax years beginning after December 31, 2017 and before January 1, 2026.

these new pass-through entity taxes can qualify for a federal deduction, but rather discusses how California may potentially update its tax laws to address certain collateral implications of these new state income tax regimes that may affect California residents.

Specifically, in states where the pass-through entity tax is elective (*i.e.*, a choice of the pass-through entity or its owners), the issue arises of whether the tax is “imposed” within the meaning of California’s statute allowing S corporation shareholders to treat their pro-rata share of entity level net income taxes as though they paid the tax directly. Current law does not clearly address whether elective entity level taxes are “imposed” for purposes of claiming the OSTC on the S corporation shareholder’s pro-rata share of such taxes. This ambiguity arises from the nature of elective regimes being a choice rather than a requirement. Due to the number of states that have adopted (or are considering) elective pass-through entity taxes in the wake of the TCJA, this paper proposes that California’s Legislature consider amending CRTC Section 18006 to clarify that when another state adopts an elective pass-through entity tax, an election to pay the tax at the entity level will not affect the ability of an S corporation’s owners to treat the tax as though directly paid by themselves.

## **DISCUSSION**

### **I. CURRENT LAW AND REASON FOR PROPOSED CHANGE**

#### **A. Current Treatment of Net Income Taxes Paid by a Partnership or S-Corporation Under CRTC Section 18006**

CRTC Section 18001 generally allows California residents to claim a personal income tax credit against the net tax (as defined in CRTC Section 17039) for any net income taxes paid to another state “on income derived from sources within that state” that is also taxable in California.<sup>9</sup> In addition to amounts paid directly by a California resident, CRTC Section 18006 allows a partner in a partnership or a shareholder in an S corporation to treat their pro-rata share of net income tax paid by the pass-through entity as though paid directly by the partner or shareholder. Specifically, CRTC Section 18006 provides:

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<sup>9</sup> CAL. REV. & TAX. CODE § 18001(a)(1).

**“18006(a)** 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.

**18006(b)(1)** A shareholder of a corporation that is an S corporation under Chapter 4.5 (commencing with Section 23800) of Part 11 is allowed to treat his or her pro rata share of net income taxes paid to another state by the S corporation as if those taxes had been paid by the shareholder.

**18006(b)(2)** This subdivision applies only if either of the following requirements is met:

**18006(b)(2)(A)** The state imposing the tax does not allow corporations to elect to be treated as an S corporation.

**18006(b)(2)(B)** The state imposes a tax on S corporations and the corporation referred to in paragraph (1) has elected to be treated as an S corporation in the other state.”

Restated more simply, CRTC Section 18006(a) allows qualifying net income taxes paid by the partnership to be treated as though they were paid directly by the its partners for OSTC purposes. Somewhat similarly, 18006(b) allows net income taxes imposed on an S corporation to be treated as paid directly by the S corporation’s shareholders when either: (1) the state does not allow for S corporation treatment, or (2) the state honors S corporation treatment but imposes a net income tax on corporations electing S corporation status.<sup>10</sup>

The phrasing of subdivision (a) of Section 18006 extends to cover all net income taxes “*paid to another state* by the partnership.”<sup>11</sup> Because this language hinges only on whether the tax is “*paid*,” it reads in a manner that appears agnostic as to whether the partnership net income tax is elective or mandatory – *i.e.*, so long as the net income tax is “paid” by the partnership, it appears to be covered under CRTC Section 18006(a). On the other hand, for

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<sup>10</sup> California is a prime example of a state that imposes a net income tax on corporations electing S corporation treatment. Specifically, under CRTC Section 23802 California imposes its corporation income or franchise tax on S corporations at a rate of 1.5% (or 3.5% if the S corporation qualifies as a financial corporation).

<sup>11</sup> CAL. REV. & TAX. CODE § 18006(a). (emphasis added).

corporations electing S corporation treatment, subdivision (b)(2)(B) of Section 18006 applies when “*the state imposes* a tax on S corporations” and the corporation has elected S corporation treatment in such other state.<sup>12</sup> Unlike the language of subdivision (a), subdivision (b) could be interpreted to hinge on whether the state “imposes” the tax, and not merely whether any tax is paid at the entity level. For this reason, the issue arises of whether elective net income taxes paid by an S corporation fall squarely within the purview of CRTC Section 18006(b).

The meaning of the word “impose” was analyzed in some detail by the California Court of Appeals in *Ponderosa Homes, Inc. v. City of San Ramon*. At issue in *Ponderosa Homes, Inc.* was whether a fee was “imposed” at the time when a conditional approval first notified the taxpayer that the fee would be due, or at the later point in time when the fee was actually paid. To the issue of what it means for a fee or tax to be “imposed,” the court wrote that “[t]he phrase ‘to impose’ is generally defined to mean to establish or apply by authority or force, as in ‘to impose a tax.’ (Webster's Third New Internat. Dict. (1970) p. 1136.”<sup>13</sup> Further, the court noted that a fee is “imposed” when “required by authority of government.”<sup>14</sup> When viewed through the lens of whether a levy is “forced” or “required by authority of government,” it is not clear whether an elective pass-through entity tax is truly “imposed” for purposes of CRTC Section 18006(b)(2)(B).

The word “imposes” also appears in California Code of Regulations (“CCR”) Section 25122(b) to help define when a taxpayer is “taxable” in another state for purposes of allocation and apportionment of income under California’s Uniform Division of Income for Tax Purposes Act (“UDITPA”). CCR Section 25122(b)(1) provides that a taxpayer is “subject to tax” in another state when “it carries on business activity in such state *and such state imposes such a tax thereon.*”<sup>15</sup> Addressing voluntary tax filings, this regulation provides that “if the taxpayer voluntarily files and pays one or more such taxes when not required to do so,” the taxpayer *will not* be considered subject to tax if (A) it does not engage in business in the state, or (B) engages in some

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<sup>12</sup> CAL. REV. & TAX. CODE § 18006(b)(2)(B). (emphasis added).

<sup>13</sup> *Ponderosa Homes, Inc. v. City of San Ramon*, 23 Cal. App. 4th 1761, 1770 (Cal. Ct. App., 1994); See also *California Cannabis Coalition v. City of Upland*, 3 Cal. 5th 924 (Cal., 2017). (Citing the definition of “imposes” in *Ponderosa Homes, Inc. v. City of San Ramon*).

<sup>14</sup> *Ponderosa Homes, Inc.*, 23 Cal. App. 4th at 1771.

<sup>15</sup> Cal. Code Regs. Title 18 § 25122(b)(1). (emphasis added).

business activity not sufficient for nexus and the minimum tax bears no relation to the activity in state.<sup>16</sup> Arguably, the negative implication of this regulation is that a taxpayer *is* subject to a tax imposed by another state if both voluntarily filing and doing business in such other state. The problem, however, is that this line of support for a voluntary tax filing being “imposed” is at best the negative implication of a regulation (and not the explicit language of a statute). Furthermore, CRTC Section 25122 and its accompanying regulation are explicitly defined to only apply “for purposes of allocation and apportionment of income” under UDITPA, and not in a more general manner that would extend to the OSTC under the Personal Income Tax Law. Therefore, the issue of whether an elective or voluntary entity level tax is “imposed” remains uncertain for purposes of CRTC Section 18006(b).

Although CRTC Section 18006(b)(2)(B) could arguably be interpreted to extend to elective tax regimes, the ambiguity noted above may potentially make California resident S corporation shareholders hesitant to claim the OSTC on entity level taxes electively paid by the S corporation in other states. Rather than leaving California residents uncertain as to whether their OSTC may be impacted by the S corporation electing to pay net income taxes at the entity level where available, the better approach is for California’s legislature to amend CRTC Section 18006(b) to reflect the reality that many states have adopted (or are considering) elective pass-through entity tax regimes to try to preserve the state tax deduction for their residents post-TCJA.

Provided below are brief summaries of each of the newly created elective pass-through entity tax regimes adopted in other states, and a discussion of proposed language amending CRTC Section 18006 to eliminate the uncertainty noted above for shareholders of S corporations that elect to pay entity level net income taxes in other states.

## **B. Background on Entity Level Tax Regimes Recently Adopted in Other States**

As noted earlier, the TCJA amended IRC Section 164(b)(6) for tax years beginning after December 31, 2017 and before January 1, 2026 to cap the state tax deduction for individuals to \$10,000 annually (\$5,000 if married filing separately). Since the TCJA was enacted, Connecticut has enacted a

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<sup>16</sup> *Id.*

mandatory pass-through entity tax,<sup>17</sup> and Wisconsin,<sup>18</sup> Oklahoma,<sup>19</sup> Louisiana,<sup>20</sup> and Rhode Island<sup>21</sup> have all enacted elective pass-through entity tax regimes.<sup>22,23</sup> Each of the elective regimes is summarized below. (Connecticut's pass-through entity tax is omitted because it is mandatory and therefore not subject to the same ambiguity regarding whether amounts paid to Connecticut can be treated as directly paid by a S corporation's shareholders under CRTC Section 18006(b)).

### The Wisconsin Pass-Through Entity Tax

Signed into law on December 14, 2018, Wisconsin Senate Bill 883 ("SB 883") permits S corporations in tax years beginning on or after January 1, 2018 and partnerships in tax years beginning on or after January 1, 2019 to elect to be taxed at the entity level rather than having their owners pay individual state income tax on their pro-rata share of income from Wisconsin sources.<sup>24,25</sup> Under SB 883, upon electing, the entity's income from Wisconsin sources is taxed at a rate of 7.9%,<sup>26</sup> which is slightly higher than Wisconsin's top marginal individual income tax rate of 7.65%.<sup>27</sup> Additionally, when this election is made, the pass-through entity becomes subject to additional limitations such as not being allowed to claim a net operating loss deduction,<sup>28</sup> and being disallowed from claiming most income tax credits.<sup>29</sup>

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<sup>17</sup> Connecticut Senate Bill 11 signed June 7, 2018.

<sup>18</sup> Wisconsin Senate Bill 883, signed December 14, 2018.

<sup>19</sup> Oklahoma House Bill 2665, signed April 29, 2019.

<sup>20</sup> Louisiana House Bill 547, signed June 17, 2019.

<sup>21</sup> Rhode Island House Bill 5151, signed July 5, 2019.

<sup>22</sup> The IRS has not yet opined on whether pass-through entity tax regimes such as those enacted in Connecticut, Wisconsin, Oklahoma, Louisiana, and Rhode Island can qualify for federal deduction notwithstanding the limitation contained in IRC Section 164(b)(6). This discussion paper is not intended to opine on whether net income taxes shifted to a pass-through entity can qualify for federal deduction, and is only intended to discuss how California may potentially update its tax laws to address the recent evolution of these tax regimes since the enactment of the TCJA.

<sup>23</sup> Since the TCJA was passed in December of 2017, pass-through entity tax bills have been proposed (but not enacted) in four additional states: Arkansas, Michigan, Minnesota, and New Jersey.

<sup>24</sup> Under the analysis by the Legislative Reference Bureau in the preamble to SB 883, "Persons who hold more than 50 percent ownership of the pass-through entity must consent to the election and must consent to any revocation of the election." See also WIS. STAT. § § 71.21 (6), 71.365 (4m).

<sup>25</sup> 2017 General Session (Act 368), Section 21(1)

<sup>26</sup> WIS. STAT. § § 71.21 (6), 71.365 (4m).

<sup>27</sup> See WIS. STAT. § 71.06(1p) for Wisconsin's top rate in 2018.

<sup>28</sup> WIS. STAT. § § 71.21 (6)(d)2., 71.365 (4m)(d)3.

<sup>29</sup> WISC. STAT. § § 71.21 (6)(d)3., 71.365 (4m)(d)2.

Concerning the effect of the election on partners or shareholders of an electing pass-through entity, when such an election is made, the partners or shareholders of the pass-through entity will exclude their proportionate share of all items of income, gain, loss, or deduction from the pass-through entity from the computation of their Wisconsin adjusted gross income.<sup>30</sup>

### The Oklahoma Pass-Through Entity Tax

Signed into law on April 29, 2019, Oklahoma House Bill 2665 (“HB 2665”), dubbed the “Pass-Through Entity Tax Equity Act of 2019,” created an electively available Oklahoma pass-through entity tax in tax years beginning on or after January 1, 2019. Under HB 2665, the election can be made by any entity having income reportable to another person under either Subchapter K or Subchapter S of the IRC (*i.e.*, partnerships or S corporations). Oklahoma’s elective pass-through entity tax is computed differently based on the type of pass-through entity owner, with the highest individual rate (5%) applying to individual owners, and a 6% rate applying if the owner is another pass-through entity, corporation, or a financial institution.<sup>31</sup> The tax for each of the pass-through entity member’s distributive share of income is then aggregated to calculate the total Oklahoma pass-through entity tax for the year in which the election is made.<sup>32</sup>

From the perspective of the pass-through entity’s owners, any item of income, gain, loss, or deduction that in the absence of the pass-through entity tax election would be allocated to the owner is generally removed from the computation of the owner’s Oklahoma taxable income.<sup>33</sup> Further, Oklahoma House Bill 2665 provides that if a nonresident individual’s only Oklahoma source income relates to the electing pass-through entity’s Oklahoma activities, the individual owner is not required to file an individual Oklahoma tax return for the year in which the election is effective.<sup>34</sup>

### The Louisiana Pass-Through Entity Tax

Signed into law on June 22, 2019, Louisiana Senate Bill 223 (“SB 223”)

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<sup>30</sup> WISC. STAT. § § 71.21 (6)(b), 71.365 (4m)(b).

<sup>31</sup> OKLA. STAT. tit. 68, § 2355.1P-4.

<sup>32</sup> OKLA. STAT. tit. 68, § 2355.1P-4.A.2.

<sup>33</sup> OKLA. STAT. tit. 68, § 2358.A.11.

<sup>34</sup> OKLA. STAT. tit. 68, § 2355.1P-4.E.



allows an S corporation or any other entity taxed as a partnership (so long as it does not file a composite partnership return) to elect to pay Louisiana income tax at the entity level rather than at the partner or shareholder level. SB 223 provides that this election will be effective for the year in which it is made, and will continue in future years until affirmatively terminated.<sup>35</sup> Once made, this election causes the pass-through entity to compute its Louisiana tax using a graduated rate structure with the first \$25,000 of taxable income taxed at 2%; taxable income from \$25,001 to \$100,000 taxed at 4%, and taxable income of greater than \$100,000 taxed at 6%.<sup>36</sup> Additionally, the Louisiana law allows an entity that has made this election to claim a deduction in an amount equal to the federal income tax the entity would have paid on its Louisiana net income for the taxable year if it had been required to file a federal income tax return as a C corporation.<sup>37</sup>

From a partner or S corporation shareholder perspective, the owners of an electing entity may exclude the related items of net income or from their Louisiana individual income tax returns so long as a proper election has been made, and an entity level return has been filed.<sup>38</sup>

### The Rhode Island Pass-Through Entity Tax

Signed into law on July 5, 2019, Rhode Island House Bill 5151 (“HB 5151”) created an elective pass-through entity tax available in taxable years beginning on or after January 1, 2019 to S corporations, entities taxed as partnerships for federal purposes, and some sole proprietorships.<sup>39</sup> This election is available on an annual basis, and once made the pass-through entity will pay tax at a rate of 5.99%, which is the same as Rhode Island’s highest marginal rate for individuals.<sup>40</sup> For purposes of the pass-through entity tax, “net income” is defined as ordinary income, net rental real estate income, guaranteed payments, and other business income less specially allocated depreciation and deductions allowable under IRC Sec. 179.<sup>41</sup> Net income for purposes of the tax excludes specially allocated investment income or any

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<sup>35</sup> LA. REV. STAT. § 287:732.2.A.(3), (4).

<sup>36</sup> LA. REV. STAT. § 287:732.2.B.

<sup>37</sup> LA. REV. STAT. § 287:732.2.C.

<sup>38</sup> LA. REV. STAT. § 297:14.A.

<sup>39</sup> “Pass-through entity” is defined in R.I. GEN. LAWS § 44-11-2.3(a)(4), as amended by HB 5151.

<sup>40</sup> R.I. GEN. LAWS § 44-11-2.3(b)(1).

<sup>41</sup> R.I. GEN. LAWS § 44-11-2.3(a)(2).

other types of deductions.<sup>42</sup>

For pass-through entity owners, the new pass-through entity tax does not absolve the need to file a return if the owner's only Rhode Island activity relates to the pass-through entity (like the Oklahoma regime). Rather, HB 5151 provides a personal income tax credit to be claimed on the owner's Rhode Island personal income tax return for their pro-rata share of entity level taxes paid.<sup>43</sup>

## II. DISCUSSION OF PROPOSED AMENDMENT AND FEASIBILITY

### A. Proposed Amendment to CRTC Section 18006

The authors of this discussion paper believe that CRTC Section 18006(b)(2)(B) can be amended to clarify that a shareholder's pro-rata share of both mandatory and elective S corporation net income taxes can be treated as directly paid by the shareholder. Accordingly, Exhibit A proposes to amend CRTC Section 18006 as follows:

#### **Section 18006 – Credit to member of partnership or S corporation shareholder for tax paid to another state**

For purposes of determining a credit under Section 18001 (relating to residents) or Section 18002 (relating to nonresidents), both of the following apply:

**18006(a)** 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.

**18006(b)(1)** A shareholder of a corporation that is an S corporation under Chapter 4.5 (commencing with Section 23800 ) of Part 11 is allowed to treat his or her pro rata share of net income taxes paid to another state by the S corporation as if those taxes had been paid by the shareholder.

**18006(b)(2)** This subdivision applies only if either of the following requirements is met:

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<sup>42</sup> *Id.*

<sup>43</sup> R.I. GEN. LAWS § 44-11-2.3(d).

**18006(b)(2)(A)** The state imposing the tax does not allow corporations to elect to be treated as an S corporation.

**18006(b)(2)(B)** The state imposes a tax on S corporations, either on a mandatory or elective basis, and the corporation referenced in paragraph (1) has elected to be treated as an S corporation in the other state.

## **B. Proposal Feasibility and Evaluation of Collateral Issues Related to Other State Pass-Through Entity Taxes**

We believe that the statutory amendment in Exhibit A provides a long-term, narrowly tailored solution that resolves the uncertainty whether a California resident shareholder of an S corporations electing to pay entity level tax in another state may treat their pro-rata share of such taxes as paid directly by themselves. Consistent with the background discussion provided above, this proposed amendment is localized to subdivision (b) of CRTC Section 18006, because the current language of subdivision (a) reads to encompass all entity level taxes “paid” by a partnership irrespective of whether they are mandatory or elective. The authors of this discussion paper believe this narrowly tailored amendment will eliminate any ambiguity regarding the OSTC for the elective pass-through entity tax regimes currently existing in Wisconsin, Oklahoma, Louisiana, and Rhode Island, as well as for any similar regimes adopted by other states in the future.

Notably, several of the pass-through entity tax regimes discussed above contemplate a tax rate slightly higher than the rate structure applicable to owners of non-electing pass-through entities (*e.g.*, Wisconsin, Oklahoma, and Rhode Island), or change the available credits and deductions for electing entities (*e.g.*, Oklahoma, Louisiana, and Rhode Island). The authors of this paper carefully evaluated whether additional amendments to CRTC Section 18006 are warranted to account for these divergences between the rules applicable to electing and non-electing pass-through entity owners.<sup>44</sup> For the

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<sup>44</sup> One possible way in which this could have been effected would be to add another subsection to CRTC Section 18006 providing a limitation when an election occurs. The provision would potentially limit the amount of entity level net income tax treated as paid directly by a pass-through owner to the individual income tax due on the owner’s pro-rata share of the pass-through entity from sources within that state had the election not been made.

reasons discussed below, we concluded that these differences do not warrant any additional proposed amendments to CRTC Section 18006.

First, this conclusion follows from that fact that CRTC Section 18006 only allows pass-through entity owners to treat their pro-rata share entity level taxes as though they paid the tax directly. This statute *does not* interfere with other limitations California places on OSTC, such as the limitation under CRTC Section 18001(a)(3) limiting the OSTC to the product of (1) the claimant's "net tax" payable to California under Part 10 of the CRTC (*i.e.*, computed using California's personal income tax rates), and (2) the ratio that their income taxable in both California and the other state bears to their total income taxable under Part 10 of the CRTC. Functionally, the limitation in CRTC Section 18001(a)(3) exists to cap the OSTC in situations where the other state tax rate exceeds the tax rate applicable in the home state (in this case, California). This type of home state tax rate limitation is commonplace in most other states' OSTC statutes as a mechanism to cap the OSTC when the other state has a tax rate that exceeds the home state tax rate structure.

Second, by analogy, California has never sought to limit the OSTC available to pass-through entity owners electing to file on a composite or group return basis in another state, which frequently triggers the application of a tax rate higher than that which would apply in the absence of the composite return election. Although composite return elections function somewhat similarly to an election to pay the tax at the entity level, California has not historically imposed additional OSTC limitations when composite return elections are made in other states. Rather, California has relied on the existing limitations in CRTC Section 18001 and the regulations thereunder (*e.g.*, the limitation in CRTC Section 18001(a)(3)) to handle these situations. Therefore, the small computational differences in some of the elective pass-through entity tax regimes discussed above (which are not unlike those applicable to composite return filers in many states) do not appear to warrant any further proposed amendments to CRTC Section 18006.

Concerning the legislative feasibility, it is unknown whether the amendments described in Exhibit A would have any quantifiable impact on California's tax revenues. Absent an election to pay pass-through entity tax in any of the states noted above, California residents would still claim the OSTC on the tax paid on their pro-rata share S corporation income from other state

sources, which frequently occurs through nonresident and composite return filings in other states. Thus, we believe that that the revenue impact of this amendment is likely neutral or de minimis.

### III. CONCLUSION

It is well known that the TCJA's \$10,000 state tax deduction limitation is projected to adversely impact California residents more than residents of any other state, and that the FTB has studied this issue in detail.<sup>45</sup> Furthermore, California's legislature has explored several approaches to preserving the federal deductibility of California state taxes, including trying to establish a charitable trust (the California Excellence Fund) and offering a compensatory personal income tax credit for charitable contributions made thereto.<sup>46</sup> With these prior efforts in mind, the amendment proposed in Exhibit A would serve as a practical show of support for the efforts of other states to preserve the federal deductibility of state taxes, while at the same time eliminating uncertainty faced by California resident S corporation shareholders seeking to pay taxes at the entity level wherever possible in an attempt to preserve the federal deductibility of state taxes. The authors of this paper thank you for your consideration of this matter.

**The comments contained in this paper are the individual views of the authors who prepared them and do not reflect the positions of Grant Thornton LLP, the FTB, the State Bar of California, or the Taxation Section.**

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<sup>45</sup> The FTB has issued four detailed reports on the impact of the TCJA in California, the last of which was published on March 4, 2018.

<sup>46</sup> See Senate Bill 227, passed on January 30, 2018. Later in 2018, the IRS released guidance largely negating the feasibility of this approach through the issuance of Notice 2018-54 and Notice 2018- 122.

## EXHIBIT A

### California Codes, REVENUE AND TAXATION CODE, DIVISION 2 OTHER TAXES, PART 10 PERSONAL INCOME TAX, CHAPTER 12 CREDIT FOR TAXES PAID

#### **Section 18006 – Credit to member of partnership or S corporation shareholder for tax paid to another state**

For purposes of determining a credit under Section 18001 (relating to residents) or Section 18002 (relating to nonresidents), both of the following apply:

**18006(a)** 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.

**18006(b)(1)** A shareholder of a corporation that is an S corporation under Chapter 4.5 (commencing with Section 23800 ) of Part 11 is allowed to treat his or her pro rata share of net income taxes paid to another state by the S corporation as if those taxes had been paid by the shareholder.

**18006(b)(2)** This subdivision applies only if either of the following requirements is met:

**18006(b)(2)(A)** The state imposing the tax does not allow corporations to elect to be treated as an S corporation.

**18006(b)(2)(B)** The state imposes a tax on S corporations, either on a mandatory or elective basis, and the corporation referenced in paragraph (1) has elected to be treated as an S corporation in the other state.