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TaxNewsFlash

United States

No. 2022-290
September 29, 2022

California: Other state tax credit for resident owners of entities that elect PTET legislation enacted

California has enacted **Senate Bill 851**, which provides that the owner's pro rata share of California passthrough entity tax (PTET) paid by the entity must be included in the owner's California tax liability for purposes of the other state tax credit (OSTC) calculation. Specifically, the "net tax" under the California personal income tax law must be increased by the amount of PTET credit that reduces a partner's "net tax" in the tax year, thus increasing the amount that may be offset by the credit for taxes paid to other states. The legislation is effective for tax years beginning on or after January 1, 2022, and before January 1, 2026.

The amount of OSTC is computed as the lesser of:

- California tax liability x (double taxed income ÷ California adjusted gross income)
- Other State tax liability x (double taxed income ÷ other state's adjusted gross income)

Background

Senate Bill 113 previously made changes to the PTET and PTET credit, including a change to the order in which credits would be applied to offset a taxpayer's income tax liability. For tax years beginning on or after January 1, 2022, the OSTC would be taken before the PTET credit. Prior to Senate Bill 113, the taxpayer would have to use its PTET credit before the OSTC, which created the possibility that a taxpayer's California tax liability could be reduced to zero by its PTET credit before the OSTC could be utilized. In that case, the OSTC became worthless as it does not contain a carryover or refundable provision.

However, in **Tax News for June 2022**, the Franchise Tax Board (FTB) cautioned that Senate Bill 113 did not change the OSTC or its calculation. The FTB pointed to the California Schedule S Instructions, which provide that the Line 2 is the taxpayer's California tax liability without the OSTC. In other words, the California tax liability considers all other tax credits, including the PTET credit, for the OSTC calculation.

Senate Bill 851 addresses the shortcomings of Senate Bill 113 and changes the OSTC calculation by requiring the PTET credits to be included in the owner's California tax liability, and thereby, ensuring that owners of entities that elect in to California's PTET can claim the same amount of OSTC as they would if the entities did not elect in to California's PTET.

KPMG observation

The legislation does not address an issue that arises with respect to nonresident owners regarding the ordering of the PTET and withholding credits. As the law now stands, nonresidents who do not submit a waiver for withholding must take the withholding credit before applying the PTET credit. In some cases, nonresident partners may not be able to use the PTET credit in the current year, and accordingly must carry it forward to subsequent years. The FTB has indicated that legislation to resolve this issue is expected to be introduced next year.

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