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# Credit for Taxes Paid to Other States

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# Credit for Taxes Paid to Other States

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California, like the federal government, attempts to ameliorate through a tax credit[1] device the unfairness of a double personal income tax imposed on the same income by two taxing jurisdictions. Where the federal government's credit is for foreign countries' taxes, California's credit is for taxes paid by domiciliaries of California to other states, territories or possessions of the United States.[2] Prior to 1957, the credit was also allowed for taxes paid to foreign countries;[3] but in 1957 the statute was amended so as to exclude from the credit provisions taxes paid to such countries.[4]

Section 18001 (formerly section 17976) of the California Revenue and Taxation Code provides:

> Subject to the following conditions, residents shall be allowed a credit against the taxes imposed by this part for net income taxes imposed by and paid to another state on income taxable under this part:
> (c) The credit shall not exceed such proportion of the tax payable under this part as the *income* subject to the tax in the other state and also taxable under this part bears to the taxpayer's entire *income* under which the tax is imposed by this part. (Emphasis added.)

The concern of this note is with subdivision (c), which is the implementing provision of section 18001.[5] When broken down and expressed as a formula, it appears thus:

$$\frac{\text{Income subject to tax in both states}}{\text{Income taxed by California}} \times \text{California Tax} = \text{Tax Credit}^{6}$$

Stating the code section and setting out the formula to effectuate the section far from settles the problem of computing the credit author-

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1 The tax credit is a credit against the income tax otherwise payable, as distinguished from a deduction, which only reduces the gross income in computing the taxable income subject to the tax.

2 18 CAL. ADM. C. Reg. 17976 (a) (1) (1953).

3 CAL. REV. & T.C. § 18002.

4 CAL. REV. & T.C. § 18002 (amended by Cal. Stat. 1957, ch. 215 § 2 p. 877).

5 Although California allows credits for non-residents, this note is restricted to credits allowed California residents for taxes paid on the same income in other jurisdictions.

6 See CAL. ST. BD. OF EQUAL., May 19, 1954; CCH 1 CAL. TAX CASES ¶ 200-274; P-H STATE & LOCAL TAX SERV. *Cal.* ¶ 58089.

ized. Subdivision (c) uses the word "income" without defining its meaning, and until "income" can be equated with a type of income the formula is unworkable.

Prior to May 7, 1958, the word "income" as used in subdivision (c) was construed by the Franchise Tax Board to mean "taxable income"—that is, the income remaining after allowance of all deductions and exemptions.[7] This was the "income" which formed both the numerator and the denominator of the formula. This construction by the Franchise Tax Board was seemingly approved by the State Board of Equalization in the *Appeal of Roosevelt*,[8] decided in 1954. In that case, the Franchise Tax Board in recomputing the appellant's credit under section 17976 (now section 18001) used "taxable income" in both the numerator and the denominator of its formula under subdivision (c). As to this construction by the Franchise Tax Board, the Board of Equalization said:

> This interpretation is pursuant to a regulation of the Franchise Tax Board which has been in effect and consistently followed since 1938. . . . In our opinion it is a reasonable construction in view of both the language and purpose of the statute. (Emphasis added.)

The Board of Equalization went on to say if an ambiguity does exist, the long continued administrative interpretation should be adhered to.

In 1958 the Board of Equalization decided that there was not just an ambiguity but a construction that was clearly erroneous, in its opinion in the *Appeal of Bishop*.[9] In that case the appellants, husband and wife, were domiciliaries of California who had reported an adjusted gross income of $81,833.73, of which $69,066.44 represented gross income from another state, Oregon. Their taxable income for California purposes was $77,783.73, and for Oregon purposes was $38,852.81. The California income tax, before the allowance of any credit, was $3,167.02. The Oregon income tax imposed and paid by the appellants was $2,738.22. Thus, the appellants were entitled to a tax credit under former Revenue and Taxation Code section 17976, the the only question being how much.

Though there was no dispute that the purpose of the credit was to prevent double taxation, the Franchise Tax Board and the appellants differed as to the extent of the relief intended. Their divergence concerned the proper construction of the phrase "income subject to tax in the other state and . . . also taxable under this part" in subdivision

[7] 18 CAL. ADM. C. Reg. 17976 (b) (3) (1952).

[8] CAL. ST. BD. OF EQUAL., May 7, 1954; CCH 2 CAL. TAX CASES ¶ 200-274; P-H STATE & LOCAL TAX SERV. *Cal.* ¶ 58121.

[9] CAL. ST. BD. OF EQUAL., — 1958; CCH CAL. TAX CASES ¶ 200-879.

(c) of section 17976. The appellants argued that the word "income" as used there meant *adjusted gross income,* and computed their credit by using adjusted gross income in the formula under subdivision (c) so as to give them a maximum credit of $2,655.47.

The Franchise Tax Board argued that the meaning of the word "income" in subdivision (c) was the same as it was construed in the *Roosevelt* opinion, that is, *"taxable income."* On this basis it computed the appellants' maximum credit to be only $1,581.02. The Franchise Tax Board cited as authority for its construction the opinion of the Board of Equalization in the *Roosevelt* case.

The Board of Equalization avoiding the effect of its *Roosevelt* opinion, agreed with the appellants, stating that the point raised and decided on the *Roosevelt* appeal did not concern the construction of subdivision (c) by the Franchise Tax Board, but was concerned with whether on the facts[10] there presented the Tax Board was estopped from recomputing the credit claimed by the appellant. The Board of Equalization went on to say that since the appellant had not disputed the Franchise Tax Board's method of computing the credit, but only the question whether it was estopped from recomputing the credit, the Board of Equalization had not given the Franchise Tax Board's construction using "taxable income" in its formula a "critical analysis." It did say, though, that any statements in the *Roosevelt* opinion which were inconsistent with its *Bishop* opinion were disapproved.

The Board of Equalization pointed out in its *Bishop* opinion that the use of "taxable income" in the numerator and the denominator of the formula in computing the tax credit, as was supposedly approved in the *Roosevelt* case, produced a discriminatory tax credit apart from the taxes paid in the other state. For example, if the tax paid to the other state resulted from a small tax base combined with a high tax rate, or from a large tax base combined with a low tax rate, and the same amount of taxes were paid in both instances, by using "taxable income" in computing the tax credit the credit would be different in each case, though in both instances the same amount of money was earned in the other state as well as the same amount of taxes paid. This can be illustrated as follows: Where there is in state "A" adjusted

[10] In the *Roosevelt* appeal, *supra* note 6, the appellant contended that her attorney had telephoned the Franchise Tax Board as to the method of computing her tax credit and was advised to use "adjusted gross income" in the formula, which she did. Thus, the appellant argued, the Franchise Tax Board was estopped from assessing an additional tax by use of "taxable income" in the formula, rather than "adjusted gross income." The Board of Equalization held there was no basis for estoppel since the appellant was unable to show that the Franchise Tax Board had in fact furnished erroneous instructions concerning her return.

gross income of $5000 and taxable income of $2000 after deductions and exemptions of $3000, and a tax rate of ten per cent, the tax payable would be $200. Where there is in state "B" adjusted gross income of $5000 and taxable income of $4000 after deductions and exemptions of $1000, and a tax rate of five per cent, the tax payable in state "B" would also be $200. Though the adjusted gross income and tax payable in both states are the same, the credit where "taxable income" is used in the formula under subdivision (c) will not be the same.[11] Had "adjusted gross income" been used in the formula as was done in the *Bishop* case, the credit would have been identical in both instances.

The discriminatory result from using "taxable income" was not only unfair, but also hindered the salutary purpose of the tax credit. The result was that the amount of tax credit allowed was dependent not so much on the tax imposed by the other state as it was whether the other state had a large or small tax base, regardless of the tax imposed.

Whether the Board of Equalization had a change of heart or was in fact for the first time giving the Franchise Tax Board's method of computing the credit a "critical analysis," its opinion in the *Bishop* case seems more equitably to carry out the purpose of the statute.

The *Bishop* rule is concerned, as it should be, with the taxes paid in the state where the income is derived and not with such state's tax base, deductions and exemptions. The taxes imposed on the same income is the crux of the double taxation which Revenue and Taxation Code section 18001 attempts to alleviate. In no way will the taxpayer be given any more credit than for taxes actually paid on the same income subject to taxation in both states. Where the formula would give him a larger credit than taxes actually paid in the other state, the credit would be the lesser of the two, the taxes actually paid.

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[11] (a) $2000 (Net income in state "A") ÷ $4000 (California's hypothetical net income) × $100 (California's hypothetical tax) = $50 (Maximum tax credit).

(b) $4000 (Net income in state "B") ÷ $4000 (California's hypothetical net income) × $100 (California's hypothetical tax) = $100 (Maximum tax credit)