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BOARD OF EQUALIZATION
STATE OF CALIFORNIA

In the Matter of the Appeal of:) **HEARING SUMMARY**
) **PERSONAL INCOME TAX APPEAL**
) **MICHAEL D. RUDD AND**) Case No. 794298
) **PATRICIA J. RUDD**)

<u>Years</u>	<u>Proposed Assessments</u>
2007	\$43,321
2008	\$25,077

Representing the Parties:

For Appellants: Mark A. Loyd, Attorney
For Franchise Tax Board: Kristen Kane, Tax Counsel

QUESTION: Whether appellants have shown error in the proposed tax assessments for 2007 and 2008 based on the Franchise Tax Board's (FTB or respondent) adjustments of appellants' claimed other state tax credits (OSTCs).

HEARING SUMMARY

Overview

This appeal concerns the proper amount of OSTCs that appellants are entitled to claim on their California income tax returns for tax years 2007 and 2008 for income taxes paid to Kentucky.

1 During the tax years at issue, appellants were California residents and appellant Michael D. Rudd was a
2 shareholder of Rudd Equipment Company, Inc. (Rudd Equipment), which was taxed as a subchapter
3 S corporation for federal and Kentucky income tax purposes. For both tax years at issue, appellants
4 claimed OSTCs for Kentucky in amounts equal to their claimed income tax withholdings on their 2007
5 and 2008 Kentucky nonresident income tax returns. On audit, respondent determined that, for each tax
6 year at issue, appellants claimed an excessive amount of OSTC for Kentucky and they are only entitled
7 to claim OSTC for Kentucky in the amount of their reported Kentucky income tax liability.
8 Respondent consequently proposed an assessment of additional tax for each tax year at issue. At
9 protest, appellants changed their position and argued that, for each tax year at issue, they are entitled to
10 claim OSTC for Kentucky in the amount of their reported Kentucky income tax liability plus the
11 nonrefundable limited liability entity tax (LLET) credit they claimed on their 2007 and 2008 Kentucky
12 returns.¹ After respondent affirmed the proposed assessments, appellants filed this appeal. Both parties
13 assert the same positions on appeal that they did at protest.

14 Background

15 2007 Tax Year

16 Appellants filed a timely joint 2007 California return, reporting California adjusted gross
17 income (AGI) of \$12,280,199. After applying itemized deductions of \$99,849, appellants reported
18 taxable income of \$12,180,350 and a tax of \$1,128,383. On line 25 of the 2007 return, appellants
19 claimed an OSTC of \$339,747, which reduced the tax to \$788,636. Appellants self-assessed a mental
20 health services tax of \$111,804, which increased the tax to \$900,440. After applying payments of
21 \$773,260, consisting of California income tax withholdings of \$66,260 and 2007 estimated tax and
22 other payments of \$707,000, appellants reported a tax due of \$127,180 plus an underpayment of
23 estimated tax penalty of \$1,750 for a total amount due of \$128,930. Attached to appellants' 2007
24 return are copies of California Schedule S, Other State Tax Credit, on which appellants claimed OSTCs
25

26
27 ¹ In this hearing summary, the terms LLET, LLET credit (or LLETTC), and LLET payment are frequently used. For clarity
28 sake, appellants argue on appeal that, for each tax year at issue, they are entitled to an OSTC amount consisting of: 1) their
reported Kentucky income tax liability, which was reported on line 28 of their 2007 and 2008 Kentucky returns; plus
2) their proportionate share of the LLET paid by the company, which appellants claimed as a credit on line 15 of their 2007
and 2008 Kentucky returns.

1 for income tax liabilities paid to other states, including an OSTC of \$155,803 for Kentucky,² and
2 appellants' 2007 Kentucky return. Appellants reported S corporation income of \$2,856,852 as the
3 double-taxed income amount reported on their 2007 California Schedule S, Parts 1(b) and 1(c) for
4 Kentucky. (Respondent's Opening Br., pp. 1-2, exhibit A.)

5 On their 2007 Kentucky return, appellants reported taxable income of \$2,900,179 and
6 tax of \$173,677. After subtracting the LLET credit of \$61,181³ and a personal tax credit of \$14,
7 appellants reported a Kentucky income tax liability of \$112,482. After applying a Kentucky income
8 tax withholding credit of \$155,803, appellants claimed a refund of \$43,321. Attached to the company's
9 Kentucky S corporation income tax and LLET return (Kentucky Forms 720S) for tax year 2007 is a
10 copy of Schedule LLET, which lists Rudd Equipment's 2007 LLET as \$72,423, which is the lesser of
11 1) Rudd Equipment's gross receipts LLET of \$72,423 (Section B, line 4) or 2) Rudd Equipment's gross
12 profits LLET of \$155,143. (Apps. Opening Br., tab 1; Respondent's Opening Br., exhibit A.)

13 2008 Tax Year

14 Appellants filed a timely joint 2008 California return, reporting California AGI of
15 \$19,487,589. After applying itemized deductions of \$1,358,729, appellants reported taxable income of
16 \$18,128,860 and a tax of \$1,681,375. On line 25 of the 2008 return, appellants claimed an OSTC of
17 \$599,163, which reduced the tax to \$1,082,212. Appellants self-assessed a mental health services tax
18 of \$171,289, which increased the tax to \$1,253,501. After applying payments of \$1,417,842, consisting
19 of California income tax withholdings of \$89,842 and 2008 estimated tax and other payments of
20 \$1,328,000, appellants claimed an overpayment of tax of \$164,341. Appellants applied \$160,466 of the
21 overpayment to their 2009 estimated tax and the remaining amount of \$3,875 to an underpayment of
22 estimated tax penalty of \$3,875. Attached to appellants' 2008 return are California Schedule S, Other
23 State Tax Credit, on which appellants claimed OSTCs for income tax liabilities paid to other states,
24

25 _____
26 ² On their 2007 California return, appellants claims a total of \$339,747 of OSTCs for income tax liabilities paid to the
27 following states: 1) Illinois (\$11,606); 2) Kentucky (\$155,803); 3) Maryland (\$2,430); 4) Missouri (\$49,710); 5) Ohio
28 (\$3,388); 6) Pennsylvania (\$20,754); 7) Virginia (\$1,151); 8) West Virginia (\$94,905).

³ A copy of appellants' 2007 Kentucky Schedule K-1, Shareholder's Share of Income, Credits, Deductions, Etc. (Form
720S), calculating the shareholder's share of the nonrefundable LLET credit from Schedule K, Section II, line 9 on line 55,
is not in the appeal file. A copy of the company's 2007 Schedule K is also not included in the appeal file.

1 including an OSTC of \$234,667 for Kentucky,⁴ and appellants' 2008 Kentucky return. Appellants
2 reported S corporation income of \$5,372,990 as the double-taxed income amount reported on their
3 2008 California Schedule S, Parts 1(b) and 1(c) for Kentucky. (Respondent's Opening Br., pp. 1-2,
4 exhibit B.)

5 On their 2008 Kentucky return, appellants reported taxable income of \$4,960,940 and
6 tax of \$297,322. After subtracting an LLET credit of \$87,712⁵ and a personal tax credit of \$20,
7 appellants reported a Kentucky income tax liability of \$209,590. After applying a Kentucky income
8 tax withholding credit of \$234,667, appellants claimed a refund of \$25,077. Attached to the company's
9 Kentucky S corporation income tax and LLET return (Kentucky Forms 720S) for tax year 2008 is a
10 copy of Schedule LLET, which lists Rudd Equipment's 2008 LLET as \$101,200, which is the lesser of
11 1) Rudd Equipment's gross receipts LLET of \$101,200 (Section B, line 4) or 2) Rudd Equipment's
12 gross profits LLET of \$198,243. (Apps. Opening Br., tab 1; (Respondent's Opening Br., exhibit B.)

13 Audit

14 Respondent subsequently reviewed appellants' 2007 and 2008 California returns.
15 Respondent accepted the claimed OSTCs for all states except for Kentucky. Respondent determined
16 that, for both tax years, appellants claimed excessive amounts of the OSTC for Kentucky, which
17 equaled their Kentucky income tax withholding credits. Respondent determined that appellants were
18 only entitled to claim OSTCs for their total Kentucky income tax liabilities of \$112,482 and \$209,590
19 for tax year 2007 and 2008, respectively. Based on this finding, respondent issued Notices of Proposed
20 Assessment (NPAs) for tax years 2007 and 2008 on April 26, 2011, reducing the amounts of the
21 OSTCs and proposing additional California tax of \$43,321 and \$25,077 for 2007 and 2008,
22 respectively, plus interest.⁶ (Respondent's Opening Br., p. 3.)

23 _____
24 ⁴ On their 2008 California return, appellants claims a total of \$599,163 of OSTCs for income tax liabilities paid to the
25 following states: 1) Illinois (\$17,117); 2) Kentucky (\$234,667); 3) Maryland (\$4,765); 4) Missouri (\$67,849); 5) Ohio
26 (\$8,826); 6) Pennsylvania (\$54,023); 7) Virginia (\$2,242); 8) West Virginia (\$209,674).

27 ⁵ A copy of appellants' 2008 Kentucky Schedule K-1, Shareholder's Share of Income, Credits, Deductions, Etc. (Form
28 720S), calculating the shareholder's share of the nonrefundable LLET credit from Schedule K, Section II, line 9 on line 55,
is not in the appeal file. A copy of Rudd Equipment's 2008 Schedule K is also not included in the appeal file.

⁶ Copies of the 2007 and 2008 NPAs are not in the appeal file.

1 Appellants timely protested the 2007 and 2008 proposed assessments. Appellants
2 reportedly argued that they were entitled to a 2007 Kentucky OSTC of \$173,677 and a 2008 Kentucky
3 OSTC of \$297,322 consisting of the LLET credit and the total Kentucky income tax liability for each
4 tax year at issue.⁷ According to respondent, appellants' argument, if successful, would result in
5 refunds, rather than deficiencies, for both of the tax years at issue. Respondent acknowledged
6 appellants' protest letter in a letter dated July 12, 2011, and sent appellants a protest position letter
7 dated August 6, 2013.⁸ On January 9, 2014, respondent issued Notices of Action for tax years 2007
8 and 2008, affirming the 2007 and 2008 NPAs, and stating that appellants are not entitled to claim an
9 OSTC for amounts another state refunded because the refunded amount was not imposed by the other
10 state. (Resp. Opening Br., p. 3; Appeal Letter, attachments.)

11 This timely appeal followed.

12 Contentions

13 Appellants' Contentions

14 Appellants assert that the only issue in this appeal is whether the LLET credit constitutes
15 a payment of appellants' Kentucky income tax for the tax years at issue.⁹ Appellants assert that they
16 are nonresidents of Kentucky and that appellant Michael D. Rudd owns an interest in Rudd Equipment,
17 which is taxed as a subchapter S corporation for federal and Kentucky income tax purposes. Appellants
18 also assert that Rudd Equipment does business in Kentucky and several surrounding states and Rudd
19 Equipment paid an LLET to Kentucky for tax years 2007 and 2008. Appellants further assert that, for
20 tax years 2007 and 2008, Mr. Rudd incurred and paid a net income tax liability in each of the states in
21 which Rudd Equipment was doing business, including Kentucky, based on his distributive share of
22

23 ⁷ It appears that these OSTC claimed amounts are typographical errors in respondent's opening brief. Although the protest
24 correspondence is not in the appeal record, appellants argue on appeal that they are entitled to an OSTC of \$173,663 for tax
25 year 2007, which is the sum of appellants' 2007 LLET credit of \$61,181 and Kentucky tax liability of \$112,482, and OSTC
26 of \$297,302 for tax year 2008, which is the sum of appellants' 2008 LLET credit of \$87,712 and Kentucky tax liability of
27 \$209,590. (Resp. Opening Br., p. 3; Appeal Letter, p. 2; Apps. Opening Br., p. 3.)

28 ⁸ As indicated in footnote 2, *supra*, copies of appellants' protest letter and respondent's letters dated July 12, 2011 and
August 6, 2013 are not in the appeal file.

⁹ As noted by respondent in its opening brief, on appeal, "[a]ppellants have apparently dropped their argument regarding the
OSTC application to withholding payments[.]" (Resp. Opening Br., p. 4, fn. 7.)

1 Rudd Equipment's income in each state. (Appeal Letter, p. 2.)

2 Appellants state that Mr. Rudd "satisfied a portion of his individual income tax liability
3 attributable to his distributive share of the Company's Kentucky income with his distributive share of
4 LLET paid to Kentucky." According to appellants, the LLET credit is a payment because it is remitted
5 to Kentucky in satisfaction of the net income tax imposed by Kentucky and it "was the first amount
6 applied against Mr. Rudd's Kentucky individual net income tax liability." Citing Kentucky Revised
7 Statutes (KRS) section 141.0401(2) & (6), appellants explain that Rudd Equipment, rather than
8 appellants, paid the LLET to Kentucky:

9 An S Corporation, such as the Company, doing business in Kentucky, pays LLET to
10 Kentucky, computed based on the application of the tax rate to its gross receipts or gross
11 profits, subject to a small business exclusion (that is phased out), exemptions, and a
12 minimum tax of \$175.00; the Company paid LLET to Kentucky.

13 (Appeal Letter, pp. 2-3, fn. 2; Apps. Opening Brief, pp. 2-6; Apps. Reply Br., p. 3.)

14 On appeal, appellants contend, as they did at protest, that for tax year 2007, they are
15 entitled to an OSTC for Kentucky of \$173,663, owe no additional tax and are entitled to a refund of
16 \$17,860. Appellants assert that a 2007 OSTC for Kentucky of \$173,663 consists of the sum of the
17 LLET credit of \$61,181, which Rudd Equipment paid, and appellants' Kentucky income tax
18 withholdings of \$155,803 less appellants' Kentucky refund of \$43,321 (i.e., \$61,181 + (\$155,803 -
19 \$43,321)). According to appellants, their 2007 Kentucky income tax liability of \$173,677 was satisfied
20 with the LLET payment of \$61,181 and income tax withholdings of \$155,803, resulting in a refund of
21 \$43,321, which "equates to \$173,663.00." Appellants thus conclude that their 2007 "Kentucky net
22 income tax was \$173,663.00, and this is their OSTC for 2007." (Appeal Letter, pp. 2-4; Apps. Opening
23 Br., pp. 3, 5; Apps. Reply Br., pp. 2-3.)

24 Appellants contend that, for tax year 2008, they are entitled to an OSTC for Kentucky of
25 \$297,302, owe no additional tax and are entitled to a refund of \$62,635. Appellants assert that a 2008
26 OSTC for Kentucky of \$297,302 consists of the sum of the LLET of \$87,712, which Rudd Equipment
27 paid, and appellants' Kentucky income tax withholdings of \$234,667 less appellants' Kentucky refund
28 of \$25,077 (i.e., \$87,712 + (\$234,667 - \$25,077)). According to appellants, their 2008 Kentucky
income tax liability of \$297,322 was satisfied with the LLET payment of \$87,712 and income tax

1 withholdings of \$234,667, resulting in a refund of \$25,077, which “equates to \$297,302.00.”
2 Appellants thus conclude that their 2008 “Kentucky net income tax was \$297,302.00, and this is their
3 OSTC for 2008.” (Appeal Letter, pp. 2-4; Apps. Opening Br., p. 3, 5.)

4 Appellants contend that, for purposes of the OSTC, the LLET credit is a payment
5 because it “is for amounts paid to the State of Kentucky and satisfies the net income tax imposed by
6 Kentucky.” Appellants state that, pursuant to R&TC section 18001, subdivision (a), “a payment is an
7 amount paid to another state that satisfies the net tax imposed by that state.” Appellants assert, “A
8 payment to another state against a net income tax may be made by the taxpayer (*e.g.*, an estimated
9 payment) or by another taxpayer (*e.g.*, wage withholding, payments made on behalf of an owner, etc.,
10 by a pass-through entity).”¹⁰ Appellants assert that, by their character, the LLET are payments, even
11 though they are referred to as credits, just as “wage withholding is a payment of tax for purposes of the
12 OSTC, regardless of a statutory label as a credit.” With respect to Mr. Rudd’s California income tax
13 liability attributable to his distributive share of Rudd Equipment’s Kentucky income, appellants
14 contend that Mr. Rudd satisfied a portion with his distributive share of the LLET and the remaining
15 portion with his Kentucky income tax withholdings, both of which “the Company paid” to Kentucky.
16 Appellants thus contend that, under R&TC section 18001, subdivision (a), the OSTC includes the
17 LLET amounts, as well as the amounts of income tax paid with income tax withholdings. Appellants
18 argue that, although Kentucky statutes label the LLET as a credit, they “are indistinguishable in any
19 material way from any other income tax payments because they are remittances to [Kentucky] and
20 satisfy income tax liability dollar-for-dollar.” Appellants argue that the LLET is simply “a mechanism
21 to ensure payment of Kentucky income tax by pass-through entity owners.” (Apps. Opening Br., pp. 4,
22 6-7; Apps. Reply Br., pp. 3-4, 7-9.)

23 Appellants acknowledge that there is a distinction between a tax credit and a payment of
24 tax. Appellants state that “for purposes of the OSTC, a *credit* is an amount *not paid to another state*,
25 but a *payment* is an amount *paid to another state*[.]” According to appellants, the LLET credit is a
26 payment of tax for purposes of the OSTC because it is an amount that was paid to another state.
27

28 ¹⁰ Appellants do not provide any statutory authority or any other reference for this assertion.

1 Appellants assert that “refundability has no bearing on whether an amount is a payment for OSTC
2 purposes.” Appellants contend that respondent erroneously argues that all payments are refundable.
3 Appellants assert, “For example, a request made after the expiration of the statute of limitations for a
4 refund of a tax payment is a nonrefundable payment [see, e.g., KRS [section] 134.580(3)] but
5 nonetheless, it is still a payment.” Appellants thus conclude that “a nonrefundable amount such as the
6 [LLET credit] can be a payment.” Appellants argue that the language of R&TC section 18001,
7 subdivision (a), “does not mention refundability” and “supports [appellants’] position that a payment is
8 an amount that has been *paid to another state*.” Appellants state that they “recognize that for purposes
9 of the OSTC, a credit decreases the net income tax that is creditable, and a payment of a net income tax
10 is creditable” and “the two terms are not interchangeable and have different effects.” (Apps. Reply Br.,
11 pp. 4, 6-8.)

12 Appellants contend that respondent erroneously relies on federal income tax materials
13 that “have no bearing on what makes an amount a tax credit or a payment of tax for OSTC purposes.”
14 Appellants also contend that there is no merit to respondent’s reliance on *Rand v. Commissioner* (2013)
15 141 T.C. 376, because “the result in *Rand* turned not on some inherent distinction between a credit or a
16 payment based on nomenclature but on the text of the relevant federal tax statute.” Appellants further
17 contend that respondent’s reliance on the Internal Revenue Service’s (IRS) Coordinated Issue Paper
18 LMSB-04-0408-023 (Issue Paper), as well as “un-promulgated administrative materials” is misplaced.
19 Appellants assert that the Issue Paper is not law, it pertains to “location tax incentives,” and “federal
20 case law cited in the Issue Paper actually supports Taxpayers’ position that the [LLET credit] is a
21 payment.” (Apps. Reply Br., pp. 3-6, fn. 5.)

22 Appellants argue that there is no merit to respondent’s position that the language of
23 R&TC section 18001 requires that the resident taxpayer pay the other state tax to be entitled to claim
24 the OSTC. Appellants assert that R&TC section 18001 only requires that the net income tax be
25 imposed by and paid to another state. Appellants state that “*no text* in R&TC [section] 18001 *requires*
26 that the resident taxpayer pay the tax himself; indeed, anyone can pay it.” Appellants indicate that only
27 the California Legislature has the authority to amend the language of the statute to include such a
28 requirement. Appellants argue that the language of R&TC section 18006, which “expands the OSTC

1 credit to entity-level [net income] taxes that are not those of an individual,” does not support
2 respondent’s argument that there is “an implied limitation on the OSTC of Section 18001, which is not
3 present in or supported by Section 18001’s text.” According to appellants, R&TC section 18006 “is
4 irrelevant and not in issue.” In addition, appellants argue that, despite respondent’s contention to the
5 contrary, income tax withholdings are paid by the employer, rather than the individual employee-
6 taxpayer, and are allowed to be used for the OSTC when applied to pay taxes to another state.
7 Appellants also argue that there are other examples of payments that are allowed to be used for the
8 OSTC, even though they are not made by the taxpayer, such as “an estimated payment made to a state
9 via or by a third party, *e.g.*, check, credit card, cashier’s check, money order, etc.”¹¹ Appellants
10 contend that they are therefore entitled to claim the OSTC for the “net income tax imposed on
11 Taxpayers by Kentucky and paid by Rudd Equipment to Kentucky.”¹² (Apps. Reply Br., pp. 3-4; Apps.
12 Supp. Br., pp. 2-5, 10, fns. 3, 7.)

13 Appellants contend that there is no merit to respondent’s argument that “a credit and a
14 payment are mutually exclusive terms.” Appellants argue that the LLET credit “is an amount paid to
15 Kentucky to satisfy a net income tax for which an OSTC is provided” pursuant to R&TC section
16 18001, subdivision (a). Appellants argue that “[a]n amount labeled as a tax credit is a tax payment
17 when paid to a state under Section 18001, which provides an OSTC for ‘net income taxes imposed by
18 and paid to another state.’” Citing KRS section 141.0401(3)(b), appellant indicate that Kentucky treats
19 the LLET credit as an amount of tax paid, rather than as a credit, because “all amounts eligible for the
20 [LLET credit] must be paid to the State of Kentucky.” Citing *Beamer v. Franchise Tax Board* (1977)
21 19 Cal.3d 467, 475, appellants contend that respondent erroneously argues that the Kentucky
22 Legislature could have listed the LLET credit as a payment on the return if it intended for the LLET
23 credit to be treated as a payment because California law “dictates that [t]he nature of an amount, not its
24

25
26 ¹¹ Appellants assert that in *Henley v. Franchise Tax Bd.* (1953)122 Cal.App.2d 1, 2-5, the California Court of Appeals held
27 that, under the predecessor statute, an OSTC was proper for a Canadian tax on dividends. Citing Indiana Comm’r Directive
No. 35 (Jan. 2007), appellants claim that Indiana residents are allowed an Indiana OSTC for Kentucky tax paid by a limited
liability entity. (Apps. Supp. Br., pp. 4-5, fn. 8.)

28 ¹² Appellants cite summary decisions that may not be cited as precedent in any matter or other proceeding before the Board
pursuant to the Board’s Rules for Tax Appeals. (Cal. Code Regs., tit. 18, §§ 5551, subd. (b)(4), 5511, subd. (u).)

1 label, determines the proper characterization of that amount.” Appellants indicate that, if the Board
2 correctly determines that the LLET credit is a payment, then it should rule in favor of appellants.
3 (Apps. Reply Br., p. 1; Apps. Supp. Br., pp.5-9.)

4 Appellants argue that they would not receive double benefits by allowing the OSTC for
5 the LLET credit amounts. Appellants state that the LLET credit “was for amounts paid to Kentucky by
6 Mr. Rudd through Rudd Equipment, which satisfied the individual income tax imposed on Mr. Rudd by
7 Kentucky on his income from Rudd Equipment.” Appellants contend that, by allowing the OSTC for
8 the LLET credit amounts, a double tax would be avoided because it would mean Mr. Rudd would not
9 pay California the same LLET credit amounts that he already paid Kentucky through Rudd Equipment.
10 Appellants state, “This is entirely consistent with the policy behind the OSTC to allow relief from
11 double taxation on income.” (Apps. Reply Br., pp. 9-10; Apps. Supp. Br., pp. 9-10.)

12 In their opening brief, appellants make constitutional arguments concerning
13 respondent’s disallowance of the OSTC for the payment of the LLET. Citing *Complete Auto Transit,*
14 *Inc. v. Brady* (1977) 430 U.S. 274, as well as several subsequent cases, appellants state, “The
15 United States Supreme Court has established a four-prong test that a state taxing system such as the
16 income tax system on pass-through entities at issue here, must meet in order to pass Commerce Clause
17 muster.” According to appellants, respondent is violating “the commerce clause of the United States
18 Constitution because this disallowance subjects a multistate business such as the Company to additional
19 income tax that is not borne by businesses based solely in California.” In their supplemental brief,
20 appellants state that they “reserve all constitutional arguments and rights connected therewith for any
21 subsequent appeal in this matter.” (Apps. Opening Br., pp. 7-11; Apps. Supp. Br., p. 11 fn. 15.)

22 Respondent’s Contentions

23 Respondent argues that appellants have not met their burden of proving that the
24 proposed assessments for tax years 2007 and 2008 are erroneous. Respondent contends that appellants
25 are not entitled to claim an OSTC pursuant to R&TC section 18001 for a payment made by the
26 S corporation in which they are shareholders. Respondent contends that the language of R&TC
27 section 18001 “indicates that a resident taxpayer will be allowed an OSTC for a payment the resident
28 taxpayer made to another state” and there is no authority under R&TC section 18001 that indicates

1 “that taxpayers can take a credit for a payment made by anyone other than the taxpayer.” Respondent
2 contends that, “If the Legislature intended appellants to be able to claim a credit for payments made by
3 other entities, they would have explicitly stated so in [R&TC section] 18001, as they did in [R&TC]
4 section 18006.” According to respondent, there would be no need for R&TC section 18006 “[i]f
5 shareholders could treat any payment of the S corporation as payments they made[.]” Moreover,
6 respondent contends that it would create absurd results because “[t]axpayers could claim any payment
7 as their payment, regardless of the tangential relationship between the payment and the taxpayer,
8 reducing their taxes by the claimed amount since as a continuation of appellants’ argument, the statute
9 does not specifically state that the income taxes paid must be the taxpayer’s income taxes.” (Resp.
10 Reply Br., pp. 1-2.)

11 Respondent argues that the LLET credit is a nonrefundable tax credit, rather than a
12 payment of tax. Citing R&TC section 17093, respondent asserts “that nonrefundable tax credits are
13 part of the overall calculation in order to arrive at the amount of net tax shown on a return and not part
14 of the satisfaction or payment of that net tax after it is calculated.” Citing *Rand v. Commissioner*,
15 *supra*, 141 T.C. No. 12, respondent states, “If refundable credits taken by a taxpayer but not earned by
16 a taxpayer cannot be considered part of an underpayment, then conversely, credits used to reduce the
17 tax liability shown on a return cannot be considered a payment.” Respondent contends that credits and
18 payments “cannot be used interchangeably because they have different effects which relate to [the] total
19 income tax liability shown on a return, their ability to reduce taxes other than income tax, whether or
20 not the item is refundable, and whether or not a refund received from the item is taxable.” Respondent
21 contends that there is no merit to appellants’ argument that the LLET credit should be treated as a
22 payment for purposes of the OSTC simply because it is paid to Kentucky. Respondent agrees with
23 appellant “that the nature of a tax item and not its label should control its treatment,” but contends that
24 “the LLET credit is correctly identified as a nonrefundable tax credit, and should be treated as a
25 nonrefundable tax credit, not a payment.” Respondent contends, however, that *Beamer v. Franchise*
26 *Tax Board, supra*, 19 Cal.3d 467, is inapposite because the California Supreme Court examined “how
27 the occupation tax functioned to see if it was indeed a tax on or measured by income.” Respondent
28 states that “the LLET is a bona fide credit,” and appellants’ contention that it is a payment, rather than a

1 credit, essentially means “that all tax credits are actually payments since most tax credits are based on
2 amounts being paid.” Respondent contends that there is no merit to this argument because “this is the
3 structure of how tax credits function as determined by both the Legislatures of the United States and the
4 State of California.” (Resp. Opening Br., pp. 4-8; Respondent’s Reply Br., pp. 3-5.)

5 Applying the principles of *Beamer v. Franchise Tax Board*, *supra*, 19 Cal.3d 467,
6 respondent explains that the LLET credit functions as a credit and not like a payment.

7 The LLET credit functions like a credit in every manner. The LLET credit is used as part
8 of the calculation of tax to reduce total tax and arrive at net tax. Kentucky law lists the
9 LLET credit as a nonrefundable business incentive credit against the income tax imposed
10 by Ky. Rec. Stat 141.020. If the LLET credit is not fully utilized against income tax [it]
11 cannot be refunded, as opposed to a payment [that] is refundable. The credit cannot be
12 used against Kentucky Use tax, unlike a payment. The credit must be applied against tax
13 in the order prescribed by the Kentucky law which governs the application of income tax
14 credits. In every way the LLET credit functions as a credit. The fact that the credit is
15 generated in relation to an S corporation’s payment of tax does not change the credit’s
16 fundamental nature of [sic] as a credit.

17 (Resp. Reply Br. p. 5)

18 Respondent contends that appellants provide no legal authority for their unprecedented
19 argument that a nonrefundable tax credit, which relates to a payment of tax made by an S corporation,
20 should be treated as an income tax payment for purposes of the OSTC. Respondent states that “the
21 underlying substantive activities that generate the credit, including any amounts paid, do not relate to
22 the application of a tax credit on a tax return, and they do not change the fundamental nature of a tax
23 credit.” Respondent asserts that, although “[t]he Kentucky legislature has deemed that the payment of
24 S corporation tax is a credit worthy activity,” it nonetheless elected to allow the LLET credit as a credit.

25 Respondent states:

26 If the Kentucky Legislature desired the LLET credit to be treated as a payment it could
27 have listed it as a payment on the return, making it refundable and simple for taxpayers to
28 utilize against any type of tax. Instead, the LLET credit was implemented as a credit,
with all the restrictions that go along with credit usage. Kentucky treats this credit as a
tax credit which is part of the calculation of net tax; Respondent is treating it the same
way, and as such it is not a payment for purposes of the OSTC.

(Resp. Reply Br., p. 6.)

Respondent contends that appellants would receive a double benefit not intended by the

1 OSTC if they were allowed a credit against their California tax liability for the amount of the LLET
2 credit granted by Kentucky, “resulting in taxation in no jurisdiction rather than taxation in only one
3 jurisdiction.” Respondent asserts that the S corporation, rather than appellants, paid the S corporation
4 tax that is the basis for their OSTC claim. Respondent also asserts that Kentucky gave appellants a
5 credit that reduced the amount of their Kentucky tax liability, which appellants paid. Respondent
6 asserts, “California allowed an OSTC for the amount of tax that appellants paid, relieving them from
7 the obligation to pay California the amount already paid to Kentucky.” Respondent asserts that
8 appellants were thus “obligated to pay tax only once, to Kentucky, on their Kentucky income.” (Resp.
9 Opening Br., pp. 9-10; Resp. Reply Br., pp. 6-7.)

10 Respondent argues that appellants are attempting to obtain a benefit that “is inherently
11 contradictory to the [proper] application of the OSTC in flow through situations.” According to
12 respondent, appellants are attempting to claim an OSTC pursuant to R&TC section 18001 that they are
13 otherwise barred from claiming pursuant to R&TC section 18006. Respondent asserts that it would
14 undermine the OSTC policy if appellants were allowed to circumvent R&TC section 18006 by
15 claiming an OSTC pursuant to R&TC section 18001. Respondent explains:

16 [R&TC] section 18006 allows shareholders in an S corporation to be treated as if they
17 paid a pro-rata share of S corporation tax to a state, and claim that amount as an OSTC.
18 However, the tax paid to the other state must be on net income rather than gross income.
19 The policy behind allowing the credit on net income only is, if California allowed a credit
20 for taxes paid on gross income it would allow credit for more than the income that is
21 taxed under California law. The policy of the OSTC is to allow relief from double
22 taxation on only the income California would tax, not to grant a taxpayer credit for more
23 than would be taxed under California law. Kentucky’s S corporation tax is a gross
24 income tax; as such, appellants are not allowed a credit under [R&TC] section 18006 due
25 to the operation of law and policy.

26 (Resp. Reply Br., p. 7.)

27 Lastly, respondent addresses appellants’ constitutional challenges to the application of
28 R&TC section 18001 in this appeal. Citing California Constitution, article III, section 3.5, *Appeal of
Aimor Corp.* 83-SBE-221, decided on October 26, 1983, and the Board’s Rules for Tax Appeals (Cal.
Code Regs., tit. 18, § 5000 et seq.) section (Regulation) 5412, subdivision (b)(1), respondent contends
that the Board lacks jurisdiction “to declare a statute, such as [R&TC] section 18001, unconstitutional

1 or unenforceable absent an appellate court determination to that effect.” In addition, respondent asserts
2 that in *Crocker-Anglo National Bank v. Franchise Tax Board* (1960) 179 Cal.App.2d 592, 595, the
3 California Court of Appeals held that R&TC section 18001 was constitutional. (Resp. Opening Br.,
4 pp. 11-12.)

5 Applicable Law

6 Burden of Proof

7 Tax credits are a matter of legislative grace and a taxpayer has the burden of showing an
8 entitlement to the claimed tax credits. (*INDPOCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84;
9 *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440; *Appeal of Robert R. Telles*, 86-SBE-061,
10 Mar. 2, 1986.) Statutes granting tax credits are to be construed strictly against the taxpayer with any
11 doubts resolved in respondent’s favor. (*Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th
12 1227, 1236; *Taiheiyo Cement U.S.A., Inc. v. Franchise Tax Bd.* (2012) 204 Cal.App.4th 254, 259-260.)
13 See also *Tax & Accounting Software Corp. v. United States* (10th Cir. 2002), 301 F.3d 1254, 1261;
14 *Medchem Inc. v. Commissioner* (1st Cir. 2002) 295 F.3d 118, 123.)

15 Moreover, a presumption of correctness attends respondent’s determination as to issues
16 of fact and an appellant has the burden of proving such determinations erroneous. (*Appeal of Oscar D.*
17 *and Agatha E. Seltzer*, 80-SBE-154, Jun. 29, 1980.) This presumption is a rebuttable one and will
18 support a finding only in the absence of sufficient evidence to the contrary. (*Id.*) Respondent’s
19 determination cannot, however, be successfully rebutted when the taxpayer fails to present
20 uncontradicted, credible, competent, and relevant evidence to the contrary. (*Id.*) When the taxpayer
21 fails to support its assertion with such evidence, respondent’s determinations must be upheld. (*Id.*)
22 Unsupported assertions are not sufficient to satisfy an appellant’s burden of proof. (*Appeal of Aaron*
23 *and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.)

24 OSTC

25 R&TC section 17041 imposes a tax on a California resident’s taxable income from all
26 sources. To eliminate double taxation, R&TC section 18001, subdivision (a), generally allows a
27 California resident to claim a credit against the “net tax” (as defined in R&TC section 17039) for net
28 income taxes imposed by and paid to another state on income subject to California income tax. R&TC

1 section 17039, subdivision (a), provides, in pertinent part, that, for the purpose of computing tax
2 credits, the term “net tax” means the tax imposed under R&TC section 17041 less personal exemption
3 credits. Regulation 18001-1, subdivision (a), provides in part that “[t]he credit is limited to ‘net tax,’”
4 and “no credit may be allowed for taxes imposed on gross receipts, gross income, dividends, etc., which
5 must be paid regardless of whether or not the subject of the tax constitutes net income, even though in
6 particular instances the subject taxed is net income in whole or in part.” (Cal. Code Regs., tit. 18,
7 § 18001-1, subd. (a).)

8 A member of a partnership is allowed, for purposes of obtaining an OSTC, to treat his,
9 her or its pro rata share of “net income taxes” paid to another state by the partnership as if those taxes
10 had been paid directly by the partner. (Rev. & Tax. Code, § 18006, subd. (a).) Similarly, a shareholder
11 of a corporation electing to be treated as an S corporation for California tax purposes shall be allowed,
12 for purposes of applying an OSTC, to treat his or her pro rata share of “net income taxes” paid to
13 another state by the S corporation as if those taxes had been paid by the shareholder. (Rev. & Tax.
14 Code, § 18006, subd. (b)(1).) R&TC section 18006, subdivision (b), only applies if either of the
15 following two requirements is satisfied: (1) the state imposing the tax does not allow corporations to
16 elect to be treated as an S corporation; or (2) the state imposes a tax on S corporations and the
17 corporation has elected to be treated as an S corporation in the other state. (Rev. & Tax. Code,
18 § 18006, subd. (b)(2).)

19 Kentucky LLET

20 KRS section 141.0401, subdivision (2)(a), provides, “For taxable years beginning on or
21 after January 1, 2007, an annual limited liability entity tax shall be paid by every corporation and every
22 limited liability pass-through entity (LLPTE) doing business in Kentucky on all Kentucky gross
23 receipts or Kentucky gross profits¹³ except as provided in this subsection.” The LLET shall be the
24 lesser of \$0.095/\$100 of Kentucky gross receipts or \$0.75/\$100 of Kentucky gross profits; there is a
25 minimum LLEC tax of \$175 on each corporation and LLPTE. (KRS § 141.0401, subd. (2).)
26 According to the website of the Kentucky Department of Revenue, “The tax imposed by KRS [section]
27 _____
28

¹³ Kentucky gross profits are defined as Kentucky gross receipts reduced by returns and allowances attributable to Kentucky gross receipts less the cost of goods sold attributable to Kentucky gross receipts. (KRS § 141.0401, subd. 1(e).)

1 140.0401 is a tax imposed on those entities with limited liability in the state of Kentucky and not an
2 income tax.” (<http://revenue.ky.gov/Business/faqsct.htm>.)

3 An individual who is a member, shareholder, or partner of an LLPTE shall be allowed a
4 nonrefundable LLET credit equal to the individual’s proportionate share of the LLPTE’s LLET after it
5 is reduced by the minimum tax due of \$175 and any other nonrefundable credits. The LLET credit
6 shall be applied only to income tax assessed on the individual’s proportionate share of income from the
7 LLPTE. (KRS § 141.0401, subd. (3)(b).) Similarly, a corporation that is a partner or member of an
8 LLPTE is allowed a nonrefundable LLET credit equal to the corporation’s proportionate share of the
9 LLPTE’s LLET after it is reduced by the minimum tax due of \$175 and any other nonrefundable
10 credits. The LLET credit shall be applied only to income tax assessed on the corporation’s
11 proportionate share of income from the LLPTE. (KRS § 141.0401, subd. (3)(a).)

12 Statutory Interpretation

13 “While ‘tax exemption provisions must be strictly construed in favor of the taxing
14 agency and against the taxpayer . . .’ the ‘construction must be fair and reasonable with due regard for
15 the ordinary meaning of the language used and the objective sought to be accomplished.’”
16 (*Taiheiyo Cement U.S.A., Inc. v. Franchise Tax Bd.*, *supra*, 204 Cal.App.4th at p. 260 (citations
17 omitted).) The goal of statutory construction is to determine legislative intent, and the first step in
18 doing so is to look to the words of the statute. (*Ordlock v. Franchise Tax Bd.* (2006) 38 Cal.4th 897,
19 909-910 (*Ordlock*); *Lennane v. Franchise Tax Bd.* (1994) 9 Cal.4th 263, 268 (*Lennane*); *Lungren v.*
20 *Deukmejian* (1988) 45 Cal.3d 727, 737 (*Lungren*).) The words of the statute are given their ordinary
21 meaning but are considered in the context of the relevant statutory scheme. (*Ordlock, supra*, 38 Cal.4th
22 at pp. 909-910 [citing *Lungren, supra*, at p. 735].) “If the statutory language is clear and unambiguous,
23 then we need go no further.” (*Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508,
24 557 [citing *Lungren, supra*, at p. 735]; see also *Lennane, supra*, 9 Cal.4th at p. 268.) In determining a
25 statute’s meaning, “courts should, if possible, accord meaning to every word and phrase in a statute so
26 as to better effectuate the Legislature’s intent.” (*Ste. Marie v. Riverside County Regional Park &*
27 *Open-Space District* (2009) 46 Cal.4th 282, 289 (*Ste. Marie*) (citations omitted).)

28 When the language of a statute “is susceptible of more than one reasonable

1 interpretation,” the California courts consider “a variety of extrinsic aids, including the ostensible
2 objects to be achieved, the evils to be remedied, the legislative history, public policy, contemporaneous
3 administrative construction, and the statutory scheme of which the statute is a part.” (*Eel River*
4 *Disposal & Resource Recovery, Inc. v. County of Humboldt* (2013) 221 Cal.App.4th 209, 227 (citations
5 omitted)) The California courts should “select the construction that comports most closely with the
6 apparent intent of the Legislature, with a view toward promoting rather than defeating the general
7 purpose of the statute, and avoid an interpretation that would lead to absurd consequences.” (*Id.*
8 (citations omitted)) Furthermore, the California courts “are required to harmonize statutes by
9 considering a particular clause or section in ‘the context of the . . . statutory scheme of which it is a
10 part.’” (*Id.* (citing *Ordlock, supra*, 38 Cal.4th at p. 909).)

11 While an agency’s construction of a statute is reviewed independently, “significant
12 weight” is given to long-standing agency constructions of a statute. (*Hoechst Celanese Corp. v.*
13 *Franchise Tax Bd.* (2001) 25 Cal.4th 508, 557 [citing *Agnew v. State Bd. of Equalization* (1999)
14 21 Cal.4th 310, 322 and other cases]; *see also Ste. Marie, supra*, 46 Cal.4th at pp. 292-293.) In
15 *Ste. Marie*, the California Supreme Court stated, “When an administrative interpretation is of long
16 standing and has remained uniform, it is likely that numerous transactions have been entered into in
17 reliance thereon, and it could be invalidated only at the cost of major readjustments and extensive
18 litigation.” (*Ste. Marie, supra*, 46 Cal.4th at p. 293 [quoting *Whitcomb Hotel Inc. v. Cal. Emp. Com.*
19 (1944) 24 Cal.2d 753, 757].)

20 Constitutional Issues

21 Section 3.5 to Article III of the California Constitution prevents the Board from
22 determining that statutory provisions are unconstitutional or unenforceable. (*Appeal of*
23 *Aimor Corporation*, 83-SBE-221, Oct. 26, 1983.) Furthermore, the Board has a well-established policy
24 of abstaining from deciding constitutional issues in an appeal involving proposed assessments of
25 additional tax. (*Appeal of Aimor Corporation, supra.*) The Board’s Rules for Tax Appeals, section
26 5412, subdivision (b), expressly provides that the Board has no jurisdiction to hear and decide issues
27 involving whether a California statute or regulation is invalid or unenforceable under the Federal or
28 California Constitutions, unless a federal or California appellant court has already made such a

1 determination.

2 STAFF COMMENTS

3 It is staff's understating (see footnote 9) that appellants are not arguing on appeal that
4 the OSTCs should be applied to amounts equal to their Kentucky income tax withholding credits, as
5 they claimed on their 2007 and 2008 California returns.

6 Both parties are in agreement that appellants are entitled to claim OSTC for the amounts
7 of Kentucky income tax liabilities listed on line 28 of their 2007 and 2008 Kentucky returns, \$112,482
8 and \$209,590, respectively. The issue in this appeal is whether appellants are entitled to claim
9 additional OSTC for the amounts of LLET credit listed on line 15 of their 2007 and 2008 Kentucky
10 returns, \$61,181 and \$87,712, respectively. The parties should be prepared to discuss Regulation
11 18001-1, subdivision (a), which precludes an OSTC "for taxes imposed on gross receipts, gross
12 income, dividends, etc., which must be paid regardless of whether or not the subject of the tax
13 constitutes net income, even though in particular instances the subject taxed is net income in whole or
14 in part." (Cal. Code Regs., tit. 18, § 18001-1, subd. (a).) As evident from Rudd Equipment's 2007 and
15 2008 Schedules LLET, copies of which are attached to appellants' opening brief, Rudd Equipment's
16 LLET is based on its gross receipts LLET. It thus appears that any amounts that represent appellants'
17 proportionate share of the LLET would not qualify for the OSTC pursuant to Regulation 18001-1.

18 Although appellants argue that the language of R&TC section 18001, subdivision (a),
19 "does *not* require that the taxpayer himself" pay the net income tax imposed by and paid to the other
20 state (Apps. Reply Br., p. 3), it appears that Rudd Equipment-paid LLET by definition is *not* an income
21 tax, but rather a tax imposed on entities with limited liability in Kentucky, as set forth in KRS section
22 141.0401, subdivision (2)(a). The Kentucky Department of Revenue's website expressly states that the
23 LLET is not an income tax. (<http://revenue.ky.gov/Business/faqscit.htm>). Accordingly, to the extent
24 that appellants argue that the LLET credit is distinguishable from other credits because it "is an amount
25 paid to Kentucky to satisfy a net income tax for which an OSTC is provided (Apps. Reply Br., p. 5)," it
26 appears that R&TC section 18001 expressly requires that the payment for which the OSTC is claimed
27 is for *net income taxes* imposed by and paid to another state, whereas the LLET is *not* an income tax.
28