



MULTISTATE INCOME/FRANCHISE TAX

California enacts legislative fix for pass-through entity tax issue

Tax Alert

Overview

On September 28, 2022, the California governor signed [Senate Bill 851](#) (S.B. 851) into law, which corrects a potential issue where the California pass-through entity tax (“PET”) credit could cause a reduction in the other state tax credit (“OSTC”) for California residents and residents of reverse credit states (AZ, OR, and VA).^a

This Tax Alert summarizes some of the provisions of S.B. 851.

Background

Prior to the enactment of S.B. 851, the California Franchise Tax Board (“FTB”) in its [June 2022 Tax News](#) interpreted the term “net tax payable” to be tax after most credits are utilized, including the California PET credit. As such, prior to the effective date of S.B. 851, California residents consenting into inclusion in the California PET may see their OSTC reduced by the California PET credit (see our previous [Tax Alert](#) issued on June 24, 2022 for more details about this issue).

California S.B. 851

Effective for taxable years beginning on or after January 1, 2022, and before January 1, 2026, “net tax” payable shall be increased by the amount of the California PET credit which reduced “net tax”. Accordingly, a California resident or resident of a reverse credit state (AZ, OR, and VA) consenting into the California PET will not see a reduction in their OSTC as the PET credit will not reduce the “net tax” payable amount used to calculate the allowable OSTC.

The issue remains for tax year 2021

S.B. 851 is not effective for taxable years beginning before January 1, 2022. Based on the FTB's current interpretation, California residents and residents of reverse credit states (AZ, OR and VA) who consent into the California PET for the 2021 tax year may see their OSTC reduced by the CA PET credit. For many taxpayers this reduction of the OSTC could be more significant than the credit ordering issue for 2021. For the 2021 tax year the California PET credit must be utilized before the OSTC. As a result of the credit utilization ordering rules, California residents and residents of reverse credit states (AZ, OR and VA) may not be able to claim their OSTC, which is non-refundable and does not carryforward (see our previous [Tax Alert](#) issued on February 9, 2022 on updates to the credit utilization ordering rules effective for taxable years beginning on or after January 1, 2022).

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Have a question relating to this or any other pass-through entity tax regime? Reach out to one of our national multistate pass-through entity tax specialists.

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