



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
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KATHLEEN CONNELL
 Chair

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 Member

B. TIMOTHY GAGE
 Member

May 3, 2001

Chief Counsel Ruling
 20-0322

Re: *****

Dear *****,

In your letter dated ***** , you asked the following question:

When calculating the resident credit for net income taxes paid to another state, is the source of business income resulting from the sale of assets by the ***** and passed through to the named shareholders determined at the S corporation level in the case where the business income is properly classified as portfolio income for purposes of the passive activity loss provisions of Internal Revenue Codes section 469? (Revenue and Taxation Code section 17551.)

The rules for determining the source of income for allowing a resident credit for net income taxes paid to another state are those applied in determining the source of income for imposing tax on nonresidents generally. These rules provide that the source of S corporation business income is determined by reference to the activities of the S corporation and not its shareholders. Accordingly, the source of such income for allowing a credit pursuant to Revenue and Taxation Code sections 18001 and 18006 is determined by reference to the activities of the S corporation. The fact that the business income may also be portfolio income for the limited purposes of Internal Revenue Code section 469 does not change this result.

We specifically do not rule on whether the named taxpayers are residents of California and thus entitled to compute a credit for net income taxes paid pursuant to Revenue and Taxation Code section 18001 or 18006, or whether any of the other requirements of those sections are satisfied. We also do not rule on whether the income to which you refer to is in fact business income or portfolio income. This ruling is expressly limited to the question of whether business income of an S corporation also classified as portfolio income has a source by reference to where the corporate business activities are conducted for purposes of allowing residents of California a credit for net income taxes paid to another state pursuant to Revenue and Taxation Code sections 18001 and 18006.

Revenue and Taxation Code section 18001 allows residents of California a credit for net income taxes paid to another state if certain requirements are satisfied, one of which is that the income must have a source in the other state.

Revenue and Taxation Code section 18006 states that, for purposes of determining a credit for taxes paid to other states, a shareholder of an S corporation may treat his or her pro rata share of taxes paid by the S corporation as if paid by the shareholder individually, if certain conditions are satisfied.

Neither section, nor the regulations issued thereunder, provides rules for determining the source of income entering into the credit calculations. For purposes of determining gross income of nonresidents, however, the source of an S corporation shareholder's pro rata share of business income is determined by reference to the location of corporate activities. If the S corporation is conducting business entirely within one state, all of the business income has a source in that state. (*Valentino v. Franchise Tax Board* (2001) 87 Cal.App.4th 1284.) If the S corporation is conducting business in more than one state, business income is generally apportioned between the states by the use of the four-factor formula consisting of property, payroll and double weighted sales factor.

We agree that the same sourcing rules should be applied in allowing credits to residents as those applied in imposing tax on nonresidents. Accordingly, we conclude that the source of an S corporation shareholder's pro rata share of S corporation business income is determined by the location of corporate activities in the same manner that such income is sourced for nonresidents.

Treasury Regulation section 1.469-2T(c)(3) classifies certain income as portfolio income for the limited purpose of excluding such income from the definition of passive activity income subject to limitation. Such classification is limited to the application of Internal Revenue Code section 469 in other contexts and has no effect upon the sourcing of income for tax credit purpose. (Internal Revenue Code section 469(c).)

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayers and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes should they occur. This letter is a legal ruling by the Franchise Tax Board Chief Counsel within the meaning of Revenue and Taxation Code section 21012(a)(1).

Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or any notices or inquires which might be issued.

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Sincerely,

Richard Gould
Tax Counsel