



State of California
Franchise Tax Board

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12.30.13

CHIEF COUNSEL RULING 2013-04

Re: Request for Chief Counsel Ruling for *****

Dear M*. *****,

This is in response to your Chief Counsel Ruling Request of February 8, 2013, wherein you seek guidance as to the proper California taxation of income of a nonresident taxpayer received from a limited liability company.

FACTS

***** (Taxpayer), a nonresident of California, is a Founder and ***** of ***** . The ***** organization includes a number of legal entities that operate as a private equity fund (PEF) that manages over \$** ***** invested by general and limited partners. Of the total of over \$** ***** of investment commitments made by the partners of ***** , over ninety percent (90%) will be received from partners located outside of the State of California. Of the total amount actually invested, over ninety percent (90%) of funds have been invested in the equity of portfolio companies that are not incorporated or headquartered in the State of California. However, PEF operates from a principal office located in ***** , California.

PEF is managed by ***** , LLC (LLC). None of the limited partners of PEF own an economic interest in LLC.

LLC has its principal administrative office in ***** , California, where its Managing Directors, Principals, Associates, and administrative staff are employed. The principal business of LLC consists of providing services to PEF and the portfolio companies owned by

PEF, a group of companies resident in various locations around the world. As a result of its services-based business model, LLC requires no substantial assets and virtually no investment of capital by its owners.

The Managing Directors of LLC take part in the day-to-day management of LLC and its subsidiaries, with Taxpayer retaining control of LLC's activities. Employees provide various services to LLC and several entities related to LLC, including human resources, insurance, benefits, IT, legal, accounting, and procurement. All of the trade or business of LLC is conducted in California. Taxpayer stipulates that he provides services for LLC only in California.

Over eighty percent (80%) of Taxpayer's federal taxable income is derived from the separate partnerships of ***** and is reported on the Schedules K-1 issued by LLC and PEF. In general, the items reported on those Schedules K-1 may be divided into two groups:

First, as a Member, Taxpayer receives an annual allocation of the taxable income of LLC. LLC is taxed as a partnership and earns substantially all of its income by providing services to PEF and the various portfolio companies owned by PEF. As a Founder and Member of LLC, Taxpayer provides management and oversight services to LLC, but has a relatively insignificant investment of capital in LLC. LLC maintains an office in *****, California. For federal income tax purposes, substantially all of the net taxable income of LLC constitutes ordinary income which is allocated to the members as either partnership income under the rules of Internal Revenue Code (IRC) section 704(b) or as guaranteed payments under the rules of IRC section 707(c).

Second, as a Partner, Taxpayer receives an annual allocation of the taxable income of PEF, which operates as a "qualified investment partnership" as defined in California Revenue and Taxation Code (CRTC) section 17955(c).

ISSUE

Does Title 18 of the California Code of Regulations (CCR), section 17951-4(a) operate to source Taxpayer's income from LLC to California?

HOLDING

Under CRTC section 17951, the gross income of a nonresident includes only the gross income from sources within California. Further, under CCR section 17951-4(a), if a nonresident's business, trade or profession is conducted wholly within California, the entire net income therefrom is deemed to be derived from sources within this state. In his case, Taxpayer's income from LLC is thus properly sourced wholly to California under CCR section 17951-4.

DISCUSSION

As applied to Taxpayer, the income streams generated within the legal structures of PEF and LLC reflect two pools of income: income from a trade or business conducted within LLC, and income from ownership in a qualified investment partnership conducted within PEF. As noted in the following discussion, even if PEF continues to operate so as to qualify as a qualified investment partnership, the income from LLC should be allocated to California.

Taxpayer's Income from the Trade or Business of LLC Should Be Allocated Based on Where the Business of LLC is Conducted.

Although LLC's primary activities involve management services for PEF, LLC is not a qualified investment partnership. Therefore, Taxpayer must use the rules under CRTC section 17951 to determine the sourcing of his income from LLC.

Under the provisions of CRTC section 17951, a nonresident individual is subject to income tax in California on all income that is derived from sources within California. When a nonresident's business is conducted wholly within California, the net income has a source in California under CCR section 17951-4(a).

Here, all of the trade or business of LLC is conducted in California. Taxpayer stipulates that he only provides services for LLC in California. Under these facts, Taxpayer should treat one hundred percent (100%) of his allocable share of the entire income of LLC as California-source income.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer 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's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Natasha Sherwood Page
Tax Counsel