IT 06-0035-GIL 11/22/2006 CREDITS – FOREIGN TAX

General Information Letter: Explanation of computation of "double taxed income" for California.

November 22, 2006

Dear:

This is in response to your letter to the Individual Processing Unit, dated September 30, 2006, which has been forwarded to me for consideration. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www. tax.illinois.gov.

In your letter you have stated the following:

> I have received your LTR-402, Error Notice Response, dated September 25, 2006, a copy of which is enclosed. Needless to say, my frustration with the Department of Revenue and its treatment of me simply keeps growing. So far the Department has not responded to my initial response to its assessment – even though I provided the Department with a self-addressed return envelope. Five days ago, I sent a response to your ICS Payment and Correspondence Unit on the same matter to which I am again responding. The only progress I see is the Department has finally acknowledged that I am entitled to a credit on my 2005 Illinois Income Tax return for the income taxes I paid to the State of California. The bad news is the Department has now chosen to reduce that amount of income that was subject to "double" taxation and has imposed a "collection fee" on the amount it presently deems to be due. My position has not changed from the position I took when I filed my Illinois 1040 last April – I have paid 100% of the amount owed to Illinois and owe no additional taxes.
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> The applicable statute provides that
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> > The aggregate amount of tax which is imposed upon or measured by income and which is paid by a resident for a taxable year to another state or states on income which is also subject to the tax imposed by subsections 201(a) and (b) of this Act shall be credited against the tax imposed by subsections 201(a) and (b) otherwise due under this Act for such taxable year.
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> The Illinois Regulations provide that
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> > A tax qualifies for the credit only if it is imposed upon or measured by income and is paid by an Illinois resident to another state on income which is also subject to Illinois income tax.
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> The Regulations also provide instructions on how to determine double-taxed income in states that compute income in ways that are not consistent with the method used in Illinois. This is done to insure that items that are not subject to the Illinois income tax (such as retirement benefits) are not included in the calculation of double-taxed income.

It would appear that the Illinois Department of Revenue has taken the position that in determining the income subject to tax, California, through using an "apportionment factor", has included in its base income, income that is not subject to tax in Illinois. The Department has therefore reduced the amount of income that it deems to have been double-taxed and that should be reported on Schedule CR of the Illinois Income Tax Return. In point of fact, that is not the case in California. No income that was not subject to double-tax was included on Form CR.

There is no question that, in general, California includes in taxable income items that are not subject to tax in Illinois. With this said, it is also true that, for California tax purposes, California imposes its tax strictly on the income of non-residents garnered from California sources. In my case, it included in income no items that are not subject to tax in Illinois. To be more specific, all taxpayers (resident and non-resident) must calculate a California tax liability based on California's definition of taxable income. For non-residents, once the total tax is determined, the tax is divided by taxable income to determine the effective tax rate. For non-residents, the effective tax is then applied to income derived from California sources to determine the California income tax liability for the nonresident. This can be seen on page one of the California tax return (Form 540NR). Like Illinois, California starts with federal adjusted gross income. Like Illinois, adjustments are made to that adjusted gross income in order to arrive at California income subject to California Tax. Like Illinois, the California tax is then calculated based on taxable income. In my case, California taxable income, line 19, Form 540NR, in 2005 was $106,093. If I had been a California resident that is the amount of income that would have been subject to tax. The tax on that amount would have been $7,835 (line 20). My California effective tax rate was then calculated – 7,865 divided by 106,093 equals 7.39% (line 23). The total income I derived from California sources was $21,118. This consisted of rental income of $21,036 and interest income of $82.00. (A copy of the K-1 showing these amounts is attached hereto). For California purposes, the $21,118 was reduced by itemized deductions to which I was entitled in California. After itemized deductions, the income that was derived from California sources subject to the California tax was $19,537 (line 22). The California effective tax rate was then applied against that amount. $19,537 times 7.39% equals $1,444 (line 24). The $1,444 was reduced by a California exemption credit and the final amount of tax due California was $1,428 (line 27).

It cannot be more clear that the only items that were subject to the California income tax were the rental and interest income of $21,118 (subsequently reduced for deduction purposes). No items that might not be subject to tax in Illinois are included in that number. That income was included in federal adjusted gross income, line 1, IL-1040 and ultimately made subject to Illinois Income Tax.

There is no doubt that for determination of an effective tax rate, income that was not subject to tax in Illinois was included in income subject to tax in California. However, that income was utilized solely in determining the effective California Income Tax rate – not the actual tax due. Those amounts had nothing to do with the items of income that

> were ultimately taxed. Once a tax rate was determined, that rate was applied strictly to the rental and interest income that had been derived from California sources. (It has to be kept in mind that the manner in which an effective tax rate is determined in California has nothing to do with the CR calculation in Illinois. The rate of tax is not the subject of the credit calculation. The Illinois statute clearly provides that the income that is subject to double-taxation is to be considered. The only other consideration is the credit cannot exceed the tax that Illinois would otherwise impose on that double-taxed income.) The rental and interest income were also included in income subject to the Illinois income tax – and therefore double-taxed. The California tax on the double-taxed income and the income subject to the double-tax were properly reported on my Illinois Form CR and the resulting credit was properly taken on line 19 of my 2005 IL-1040. The rental and interest income were clearly subject to the double-tax and cannot be reduced artificially through an apportionment factor that never was applicable. California did not determine income subject to its tax on non-residents through an apportionment factor. Rather, it determined the effective tax rate and applied that rate against the actual income derived from California sources.
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> Again, it would be appreciated if you would re review your records in light of this letter and accept my 2005 return as originally filed.

**Response**

Section 601(b)(3) of the Illinois Income Tax Act (35 ILCS 5/601) provides, in part:

> The aggregate amount of tax which is imposed upon or measured by income and which is paid by a resident for a taxable year to another state or states on income which is also subject to the tax imposed by subsections 201(a) and (b) of this Act shall be credited against the tax imposed by subsections 201(a) and (b) otherwise due under this Act for such taxable year. The aggregate credit provided under this paragraph shall not exceed that amount which bears the same ratio to the tax imposed by subsections 201(a) and (b) otherwise due under this Act as the amount of the taxpayer's base income subject to tax both by such other state or states and by this State bears to his total base income subject to tax by this State for the taxable year.

The Department's regulation at 86 Ill. Adm. Code Section 100.2197(b)(4) provides that, in order to compute the "base income subject to tax by both such other state or states and by this State" (referred to as "double-taxed income"), a taxpayer should take into account only those items of income taxed by both states and should deduct only those expenditures for which both states allow a deduction. Section 100.2197(b)(4)(G) provides:

> Some states compute the tax liability of a nonresident by first computing the tax on all income of the nonresident from whatever source derived, and then multiplying the resulting amount by a percentage equal to instate sources of income divided by total sources of income or by allowing a credit based on the percentage of total income from sources outside the state. Other states determine the tax base of a nonresident by computing the tax base as if the person were a resident and multiplying the result by

> the percentage equal to in-state sources of income divided by total sources of income. The use of either of these methods of computing tax does not mean that income from all sources is included in double-taxed income. See Comptroller of the Treasury v. Hickey, 114 Md. App. 388, 689 A.2d 1316 (1997); Chin v. Director, Division of Taxation, 14 N.J. Tax 304 (T.C. N.J. 1994). When a state uses either of these methods of computation, double-taxed income shall be the base income of the taxpayer from all sources subject to tax in that state, as computed in accordance with the rest of this subsection (b)(4), multiplied by the percentage of income from sources in that state, as computed under that state's law; provided, however, that no compensation paid in Illinois under IITA Section 304(a)(2)(B) shall be treated as income from sources in that state in computing such percentage.

Cal. Rev. & Tax Code Section 17041(b)(2) provides that the personal income tax of a nonresident:

> shall be calculated by multiplying the “taxable income of a nonresident or part–year resident,” as defined in subdivision (i), by a rate (expressed as a percentage) equal to the tax computed under subdivision (a) on the entire taxable income of the nonresident or part–year resident as if the nonresident or part–year resident were a resident of this state for the taxable year and as if the nonresident or part–year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by the amount of that income.

This formula is mathematically identical to the computational methods described in Section 100.2197(b)(3)(G), and your credit for taxes paid to California was computed accordingly. This computation reflects the nature of California tax treatment of your retirement income and the interest on your Illinois Housing Development Association bonds. If California had excluded these items from tax, as Illinois does, your California tax before credits would have been $892 rather than the $1,444 actually imposed. California therefore taxed you on income that Illinois does not tax, and it would be contrary to the statute to allow you a credit for such tax.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b). If you have any further questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton
Deputy General Counsel – Income Tax