# Nonresidents: How to Become One and What's Taxable

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# NONRESIDENTS: HOW TO BECOME ONE AND WHAT'S TAXABLE

## DEFINITIONS

### RESIDENCY

Residency is primarily determined by examining all the facts and circumstances of each particular case. Residency is significant because:

- Residents of California are taxed on all income, regardless of source;
- Nonresidents are taxed only on income from California sources; and
- Part-year residents are taxed on all income while a resident and only on income from California sources while a nonresident.
  (R&TC §17014)

A resident is any individual who is:

- In California for other than a temporary or transitory purpose; or
- Domiciled in California, but who is outside California for a temporary or transitory purpose.
  (R&TC §17014(a))

The key question under either facet of the "resident" definition is whether the individual is present in California, or absent from California, for a temporary or transitory purpose. (***Appeal of Stephen D. Bragg*** (May 28, 2003) 2003-SBE-002) This determination cannot be based solely on the individual's subjective intent, but must instead be based on objective facts. (***Appeal of Anthony V. and Beverly Zupanovich*** (January 6, 1976) 76-SBE-002)

In situations where an individual has significant contacts with more than one state, the state with which the individual maintains the closest connections during the taxable year is the state of residence. (18 Cal. Code Regs. §17014(b); ***Appeal of Raymond H. and Margaret R. Berner*** (August 1, 2002) 2001-SBE-006-A) In the ***Appeal of Stephen D. Bragg***, supra, the Board reiterated the purpose of the residency rules to insure that all individuals who are in California for other than a temporary or transitory purpose, enjoying the benefits and protection of the state, should in return contribute to its support. The Board compiled a non-exhaustive list of objective factors helpful in determining to which state an individual maintains his or her closest connections. (18 Cal. Code Regs. §17014(a); ***Whittell v. Franchise Tax Board*** (1964) 231 Cal.App.2d 278, 231 Cal.App.2d at p. 285)

See "Checklist to help determine California residency/nonresidency" on page 85.

There is a special rule for certain U.S. government officials and their spouses under R&TC §17014(b). Such individuals are considered absent from California for a temporary or transitory purpose if domiciled in California. This rule applies to:

- Elected U.S. officials;
- Anyone on the staff of a member of the U.S. Congress; and
- Presidential appointees who are subject to Senate confirmation, other than military and Foreign Service appointees.
  (R&TC §17014(b))

"Residency" is not the same as "domicile." An individual may be a resident of California although not domiciled in California, and, conversely, may be domiciled in California without being a resident. (18 Cal. Code Regs. §17014(a))

# DOMICILE

"Domicile" is a legal term that does not have the same meaning as "residence" in California. While many states consider domicile and residence to be the same, California makes a distinction and views them as two separate concepts even though they may often overlap. For tax purposes, domicile is the place where an individual voluntarily establishes his or her true, fixed, permanent home and principal establishment, and to which place he or she has, whenever absent, the intention of returning. It is the place in which an individual has voluntarily fixed the habitation of self and family, not for a mere special or limited purpose, but with the present intention of making a permanent home, until some unexpected event shall occur to induce an adoption of some other permanent home. (18 Cal. Code Regs. §17014(c))

An individual can have only one domicile at any one time. (18 Cal. Code Regs. §17014(c)) If an individual has acquired a domicile at one place, it is retained until another domicile is acquired elsewhere. A change of domicile requires:

- Abandonment of the prior domicile;
- Physically moving to and residing in the new locality; and
- Intent to remain in the new locality permanently or indefinitely.

The California Court of Appeal and the FTB's regulations define "domicile" as the location where a person has the most settled and permanent connection, and the place to which a person intends to return when absent. (***Whittell v. Franchise Tax Board*** (1964) 231 Cal.App.2d 278; 18 Cal. Code Regs. §17014(c))

While an individual's intent will be considered when determining domicile, intent will not be determined merely from unsubstantiated statements; the individual's acts and declarations will also be considered. (***Appeal of Joe and Gloria Morgan*** (July 30, 1985) 85-SBE-078)

In order to change domicile, a taxpayer must actually move to a new residence and intend to remain there permanently or indefinitely. (***In Re: Marriage of Leff*** (1972) 25 Cal.App.3d 630, 642; ***Estate of Phillips*** (1969) 269 Cal.App.2d 656, 659)

## So why are domicile and residency important?

In some situations, a taxpayer may be domiciled in California but not be considered a resident. In this case, the individual is taxed only on income from California sources.

### Legal aspects of community property

Whether an individual's income is subject to community property law is based on the individual's domicile. (***Appeal of Bailey*** (March 8, 1976) 76-SEB-016; FTB Publication 1051A, Guidelines for Married/RDP filing Separate Tax Returns)

### Voting

California's Elections Code defines "residence" for voting purposes as a person's domicile. The FTB considers voting in California proof of residency. However, voting in another state does not automatically mean the taxpayer is a resident there.

### Military

A military member is domiciled in the state of his or her home of record. The military income may only be taxed by the domiciliary state, not by the state in which the member is stationed. (§511 of the Servicemembers Civil Relief Act (50 U.S.C. Appen. §571)); R&TC §17140.5)

> ***Example of military stationed in another state***
>
> Fred is in the Marine Corps stationed in California; he is domiciled in Florida. None of his wages are community property, and any California wages are separate property.

California treats a military member who is domiciled in California as a nonresident if the member is stationed outside California on permanent orders. In this case, the member is a nonresident of California but still domiciled in California. (§511 of the Servicemembers Civil Relief Act (50 U.S.C. Appen. §571)); R&TC §17140.5)

> ***Example of California military stationed in another state***
>
> Tex, a Marine, is a military member domiciled in California but is has been stationed on permanent orders in Florida for 15 years. Tex is domiciled in California but is a nonresident because he is on permanent orders outside of California. California may not tax his military income, and he is treated as a nonresident.

## NONRESIDENT

A nonresident is any individual who is not a resident of California. (R&TC §17015)

### 546-day rule

There is a special rule for certain individuals domiciled in California but working outside of California. R&TC §17014(d) establishes that a taxpayer is a nonresident if that taxpayer:

- Is outside of California for at least 546 consecutive days under an employment-related contract;
- Spends no more than 45 days in California during the taxable year; and
- Has less than $200,000 in intangible income (stocks, bonds, etc.) in taxable years in which the employment-related contract is in effect (this test applies to the income of each spouse separately).

The 45-day period includes time spent in California for personal or business purposes.

A spouse is also considered a nonresident if accompanying the spouse meeting the test. The spouse must also meet the 45-day rule.

This provision does not apply if the principal purpose of the individual's absence is to avoid taxes. (R&TC §17014(d)(4))

> ***Comment***
>
> In these situations, the taxpayer is still domiciled in California but is a nonresident. This means that community property rules apply.

See "California nonresidency and employment contract provisions" on page 87.

### Failing the test

If an individual domiciled in California is working outside the state for fewer than 546 consecutive days or is working outside California but does not have a contract, residency status is determined under the general "temporary or transitory purpose" rules that have evolved through numerous BOE appeals.

When taxpayers go abroad for employment that is expected to last two years or less and not indefinitely, their absence is considered for a temporary or transitory purpose. (***Appeal of Rodney Springer*** (2002) Cal. St. Bd. of Equal., Case No. 157784)

In a precedential opinion, the OTA ruled that a taxpayer who had signed a two-year contract but returned after only 13 months did not meet the test and was subject to California tax on all income. (**Appeal of Mazer**, 2020-OTA-263P)

### Using the general rule

A taxpayer could also be out of the state for fewer than 546 days and be a nonresident if the taxpayer ended his residence and domicile, left the state without the intention of returning, but — due to unexpected circumstances — returned.

***Example of nonresident for a short period of time***

Jon was a resident of California. He moved to Florida to take a permanent job in Miami. He did not have a contract, but planned to work there until his retirement some years down the line. After one year, the company closed its doors, and Jon was unemployed. He was unable to find work in Miami. He decided to move back to California, where he could live with his family until he could find another job.

He was a nonresident of California for the period he was gone because:

- He left California with no intention of returning;
- He sold his California house before he left and leased a new home in Miami;
- He moved his furniture and personal items to Florida; and
- He closed bank accounts, changed physicians, and effectively ended his ties (domicile) with California.

## Partial year not enough

A California taxpayer who went to work in Wisconsin was found to still be a California resident, even though her intent was that she would stay there permanently and her family would eventually join her. (***Appeal of Tumurbaatar*** (July 17, 2013) Cal. St. Bd. of Equal., Case No. 562927)

Unfortunately, these statements were not enough to prove nonresidency, and when her job ended early in the next year, she returned to California.

The Board heavily weighed the fact that her family never left California, but the taxpayers in this case lost on several other issues, as well:

- The taxpayer worked in Wisconsin for only the first quarter of the next year and returned to and worked in California for the rest of that year;
- The taxpayer and her husband maintained drivers licenses and vehicle registrations in California;
- The taxpayer did not use professional services in Wisconsin; and
- While the taxpayer had moved to Wisconsin for work because her husband was unemployed, he obtained employment in California.

### 546-day rule: one spouse stays in California

The Board determined wages of a spouse outside of California under the 546-day rule were community property taxable to California where they were earned by a taxpayer–husband because Taiwan is a community property country under Taiwan Civil Code, art. 1005. (***Appeal of Bai*** (March 25, 2015; released May 25, 2017) Cal. St. Bd. of Equal., Case No. 717459)

A married couple correctly excluded one-half of the wages for a spouse outside the state on an employment-related contract for the 2008–2010 years. However, the couple later amended the return to exclude 100% of the income. The Board denied their claim for refund because the income was community property, and only the husband's share was excludable. (***Appeal of Shah*** (February 24, 2015; released May 17, 2017) Cal. St. Bd. of Equal., Case No. 785085)

## TEMPORARY OR TRANSITORY PURPOSE

Whether an individual is in California for a temporary or transitory purpose depends on the facts and circumstances of each case.

Factors that may indicate an individual is a resident and not in California temporarily include:

- Ownership of real property in California;
- Sending children to California schools;
- Obtaining a California driver's license and auto registration; and
- Having family, social, and business interests in California.

If an individual comes to California for a vacation, to complete a transaction, or is simply passing through, the individual's purpose is temporary or transitory. (18 Cal. Code Regs. §17014(b))

An individual's stay is other than temporary or transitory if the individual:

- Is assigned by an employer to an office in California for a long or indefinite period;
- Returns to California with no specific plans to leave; or
- Is ill and is in California for an indefinite recuperation period.
  (18 Cal. Code Regs. §17014(b))

### Cases of absence for temporary purposes

18 Cal. Code Regs. §17014(b) provides that the state to which a person has the closest connections during the taxable year is the person's state of residence. For example:

- In the ***Appeal of Richard L. and Kathleen K. Hardman*** ((August 19, 1975) 1975-SBE-052), the Board held that the connections that a taxpayer maintains in this and other states are important objective indications of whether presence in or absence from California is for a temporary or transitory purpose;
- In the ***Appeal of Sanjay Narayan*** ((April 19, 2001) Cal. St. Bd. of Equal., Case No. 79538), the taxpayer argued that he had become an Alaska resident. While living in Alaska, the taxpayer maintained bank accounts in California and returned to California to take the California Bar Exam and be sworn in to the California State Bar. The Board held that this was enough to establish a presumption that the taxpayer intended to return to California, and the taxpayer did not present sufficient evidence to rebut this presumption; and
- To change domicile, a taxpayer must actually move to a new residence and intend to remain there permanently or indefinitely, as seen in ***Appeal of Nettie P. Collins*** ((May 31, 2001) Cal. St. Bd. of Equal., Case No. 80317). The taxpayer questioned how his income could be subject to California income tax when he resided "for the greater part of the year" in Trinidad. Although

he claimed to have spent only one month in California, the taxpayer was in California for more than a temporary or transitory purpose. His wife was a California resident domiciled in California. The couple filed a joint California resident income tax return.

## PRESUMPTION OF RESIDENCY

Any individual who spends in the aggregate more than nine months of the taxable year in California is presumed to be a resident. The presumption may be overcome by satisfactory evidence that the individual is in the state for a temporary or transitory purpose. (R&TC §17016)

The presumption of residence was overcome where the taxpayer lived in a hotel on a weekly basis, ate all of his meals out, and maintained a permanent home in another state. (***Appeal of Edgar Montillion Woolley*** (July 19, 1951) 51-SBE-005)

Affidavits or testimony of an individual and of his friends, employer, or business associates that the individual was in California for a rest or vacation, to complete a particular business transaction, or to work for a limited period of time will be sufficient to overcome any presumption of residence. In the case of individuals who claim to be nonresidents by virtue of being outside the state for other than transitory purposes, affidavits of friends and business associates as to the reasons for being outside the state should be submitted. (18 Cal. Code Regs. §17014(d)(1); ***Appeal of Ronald C. and Melinda L. Young*** (September 26, 2001) Cal. St. Bd. of Equal., Case No. 37458)

No presumption of nonresidency arises where the taxpayer spends less than nine months of the year in California. (***Appeal of Walter W. and Ida J. Jaffee*** (July 6, 1971) 71-SBE-023)

## PRESUMPTION OF NONRESIDENCY

An individual who is domiciled outside of California and maintains a permanent abode there, but whose presence in California does not exceed an aggregate of six months within the taxable year is considered to be in this state for temporary or transitory purposes.

However, the individual must not engage in any activity or conduct within California other than that of a seasonal visitor, tourist, or guest. (18 Cal. Code Regs. §17014(b))

The following connections with California will not — by themselves — cause a seasonal visitor, tourist, or guest to lose nonresident status:

- Owning or maintaining a home;
- Opening a bank account for paying personal expenses; and
- Having membership in local social clubs.

# CHANGING RESIDENCE

Individuals may want to move out of California, particularly to a nontax state, so they can avoid California tax on large amounts of income. This has become known as the "Tiger Woods effect," named for the golfer who changed his residence from California to Florida to save $5.8 million in taxes.

As California continues to raise tax rates and penalize high-income taxpayers for living here, more and more people will flee the state. With the advent of the Internet and ease of telecommuting, flight from the Golden State has become more common.

Although it is not impossible to change residency, the individual must really relocate to the new state and sever ties with California.

# BECOMING A NONRESIDENT

It is not easy to undo California residency. To the best of our knowledge, when the taxpayer keeps ties to California, the only criterion that positively establishes nonresidency is the work contract test (R&TC §17014), under which a taxpayer is employed under a contract that requires the taxpayer to be absent from California for at least 546 days.

That test doesn't apply to a taxpayer taking up permanent residence in another state and retiring. It also doesn't apply to taxpayers with $200,000 or more in intangible income. Otherwise, the tests for nonresidency are facts and circumstances.

A taxpayer who wants to become a nonresident must truly move and change residence and domicile, including:

- Selling the California home;
- Leaving California employment;
- Establishing and spending time in a residence located in the new state. This residence should be of equal size, cost, and amenities as the California home;
- Establishing business and social ties in the new state;
- Discontinuing business and social ties in California;
- Tracking e-mail and telephone calls to California from the other state to take care of business and personal transactions; and
- Using registered or certified mail to mail important documents to attorneys, accountants, and others in California.

Do not:

- Keep the home and let the children live there;
- Have children in school in California;
- Vote in California local elections;
- Have mail sent to California;
- Spend time visiting children or friends (every day spent in California will count against the taxpayer in a residency case); or
- Continue to use California physicians, dentists, or other professionals who require the taxpayer's physical presence to transact business.

In the ***Appeal of Stephen D. Bragg*** ((May 28, 2003) 2003-SBE-002), the Board included the following list of factors, which, while not exhaustive, inform taxpayers of the type and nature of connections the Board and the FTB find informative when determining residency:

- The location of all of the taxpayer's residential real property, and the approximate sizes and values of each of the residences;
- The state wherein the taxpayer's spouse and children reside;
- The state wherein the taxpayer's children attend school;
- The state wherein the taxpayer claims the homeowner's property tax exemption on a residence;
- The taxpayer's telephone records (i.e., the origination point of taxpayer's telephone calls);
- The number of days the taxpayer spends in California versus the number of days the taxpayer spends in other states, and the general purpose of such days (i.e., vacation, business, etc.);
- The location where the taxpayer files tax returns, both federal and state, and the state of residence claimed by the taxpayer on such returns;
- The location of the taxpayer's bank and savings accounts;

- The origination point of the taxpayer's checking account transactions and credit card transactions;
- The state wherein the taxpayer maintains memberships in social, religious, and professional organizations;
- The state wherein the taxpayer registers automobiles;
- The state wherein the taxpayer maintains a driver's license;
- The state wherein the taxpayer maintains voter registration and the taxpayer's voting participation history;
- The state wherein the taxpayer obtains professional services, such as doctors, dentists, accountants, and attorneys;
- The state wherein the taxpayer is employed;
- The state wherein the taxpayer maintains or owns business interests;
- The state wherein the taxpayer holds a professional license or licenses;
- The state wherein the taxpayer owns investment real property; and
- The indications in affidavits from various individuals discussing the taxpayer's residency.

# CASES

## Short trip doesn't count

A taxpayer was found to have not abandoned his California domicile after spending a week in Taiwan, during which he claimed he made arrangements to relocate there permanently. (***Appeal of Kattan*** (April 25, 2017; released December 11, 2017) Cal. St. Bd. of Equal., Case No. 926313)

The taxpayer was in Taiwan from October 10 until October 16, 2009, after which he returned to California where he stayed until he returned to Taiwan on December 29, 2009. He argued that the trip back to the United States October 16 through December was temporary in nature.

The quick residency change may have been because, on November 6, 2009, the taxpayer sold stock for a large gain.

## Using a friend's address

Taxpayers were found to be residents of California where they used the address of a friend in Las Vegas for two years while purportedly searching for a house to buy in the area. (***Appeal of Karimi Manesh*** (April 24, 2013) Cal. St. Bd. of Equal., Case No. 567197)

On appeal, the taxpayers did not present substantial evidence that they did indeed live at the Nevada address listed on their tax returns. Further investigation showed that the taxpayers:

- Were using professional services in the San Mateo area;
- Did not attempt to sell or rent their home;
- Did not make a purchase offer on a home in Nevada;
- Held multiple bank accounts in California and none in Nevada; and
- Were still registered to vote in California.

## NFL wide receiver Keyshawn Johnson

In December 2017, the Board ruled in favor of NFL wide receiver Keyshawn Johnson, ending a residency audit that had lasted for over 15 years and ruling that Johnson and his wife were nonresidents of California in 2000 through 2004. (***Appeal of Johnson*** (December 11, 2017) Cal. St. Bd. of Equal., Case No. 786255)

However, the Board ruled that he was a resident in 1996 but he was no longer a California resident or domiciliary in the remaining tax years at issue.

### Superior court slashes Keyshawn's last hope

In January 2021, a Los Angeles judge ruled against him in his claim that he was a resident of California in 1996 and owed an additional tax of $218,857 plus interest and penalties. (***Johnson v. Franchise Tax Bd.***, Cal. Super. Ct., 19STCV15515, ruling April 14, 2021)

## NBA player drops the residence ball

In a 2013 case, with almost $400,000 in extra tax on the line, NBA player Jerome James was found to be domiciled in and a resident of California while he played for the Seattle Supersonics. (***Appeal of Jerome James*** (February 26, 2013) Cal. St. Bd. of Equal., Case No. 596166) Jerome was signed to the Sacramento Kings prior to playing for Seattle, and during that time he purchased a home in Sacramento.

After he was released from the Kings, he signed with Seattle, but did not establish a permanent residence in Washington, renting furnished apartments and homes in the Seattle area during the NBA season. Meanwhile, he still maintained his home in California (and eventually also bought a second home in California) and lived there during the offseason.

Major factors that weighed against the taxpayer included:

- The taxpayer maintained most of his professional services — such as personal banker, attorney, and accountant — in California;
- Until he signed a lease in Washington, the taxpayer spent the offseason in California, only renting furnished residences in Washington during the NBA season, which did not indicate an intent to stay there permanently;
- The taxpayer formed a corporation in California;
- The taxpayer maintained his California driver's license, renewing it even while he was supposedly a resident of Washington;
- The taxpayer's Sacramento address was listed on legal documents during the period at issue; and
- If the California properties the taxpayer owned were only for investment purposes (as the taxpayer argued), there should have been some attempt to rent them out.

The court noted that in the case of professional athletes, residency is often determined by where the taxpayer chooses to go during the offseason — in this case, California.

## Taxpayer prevails

Former long-term California residents became residents of Washington state just two months before receiving an initial payment on the $40 million paid for the sale of the husband's California partnership interest. Because the sale of the husband's partnership interest was a sale of an intangible, it was sourced to their new state of residence and not taxable by California. (***Appeal of Michael and Mary Bills*** (April 28, 2016) Cal. St. Bd. of Equal., Case Nos. 610028, 782397)

**Caution**

Do not expect this result, as this case was an abnormality.

## CAN YOU STILL DO THEIR TAX WORK?

According to the FTB, whether continuing to use a California accountant will make a taxpayer (your client) a resident is a facts and circumstances matter. The retention of California tax professionals is one of many factors evaluated in a residency examination.

The FTB will consider whether or not the taxpayer:

- Has a longstanding relationship with a particular California-based tax professional;
- Is establishing a new relationship with a California-based tax professional; or
- Is establishing a new relationship with a tax professional who is based in the state of newly claimed residence.

Also, consideration will be given to what services provided by the professional, such as filing a California return, filing a federal return, or filing a return for a different state.

The focus of any inquiry regarding the retention of professionals is where the interaction between the taxpayer and the professional takes place and where the services are performed. The fact that a taxpayer forms such a relationship with a professional inside California or outside California and that same professional is either associated with or is employed by a firm with offices inside or outside of California is generally viewed as incidental and given little weight.

**Practice Pointer**

This is only one factor in the ***Bragg*** factors, which are used in totality.

***Example of relationships with a tax professional***

Ernestine, upon retirement, moved to Washington State. She has investments in many LLCs and partnerships with California-source income. She sells her California home, buys a new home in Washington, and moved her furniture there. She gets new doctors in the area, joins a church and the Rotary club in Washington. She spends little time in California and does her taxes via e-mail and the phone. Keeping his California tax professional would be reasonable because:

- She otherwise seems to have severed her ties;
- She has California-source income; and
- She works with his tax professional from Washington, rather than seeing him in California.

Edward, however, upon retirement, moved to Henderson, NV.

- He kept his California home and is leasing it.
- He lives in a furnished rental home in Nevada while he considers what to buy.
- His furniture is in storage in California.
- He has retained his membership with his California church and attends when he returns to see his doctors, dentist, and tax professional.

Edward will likely not meet the change of residence test as he has too many ties to California. However, simply firing his tax professional will not likely tip the scales in his favor because he has not severed many other ties to California.

# SELLING ASSETS AND LEAVING CALIFORNIA

If your business client wants to become a nonresident, you must help carefully plan the exit when they plan to dispose of the business. Structuring a sale too soon can make the gain taxable to California. Waiting until the client is a nonresident could save big tax dollars.

Any taxpayer who wants to move to a nontax state prior to selling a business or other asset not sourced to California must make the move and become a nonresident before the sale. This can be a bit trickier than it might seem, and the FTB pays close attention.

## Intangible income

A nonresident's income from stocks, bonds, notes, or other intangible property is generally not income from sources within California. (R&TC §17952)

Most people understand that dividends received from a publicly traded company or the capital gains derived from the sale of a publicly traded company's stock are sourced to the taxpayer's state of residence. But the provision applies equally to the sales of the stock in a closely-held corporation.

***Moving to a nontax (or lower tax) state***

Obviously, any taxpayer who wants to move to a nontax state prior to selling a closely held corporation must make the move before the sale — preferably before starting the sales process.

This can be a bit trickier than it might seem and the FTB pays close attention. A taxpayer who wants to become a nonresident must truly move and change residence, including:

- Selling the California home;
- Leaving California employment;
- Establishing and spending time in a residence located in the new state. This residence should be of equal or greater size, cost, and amenities as the California home;
- Establishing business and social ties in the new state; and
- Discontinuing business and social ties in California.

It is not easy to undo California residency. To the best of our knowledge, the only criterion that positively establishes nonresidency when the taxpayer keeps ties to California is the work contract test, under which a taxpayer is employed under a contract that requires the taxpayer to be absent from California for at least 546 days.

If however, a taxpayer leaves the state, severs ties with California and establishes permanent residence in another state they become nonresidents. The key is when did the taxpayer sever ties: this is a facts and circumstances test.

## Structuring the sale

It is the gain on the sale of stock that constitutes the intangible gain, not the gain on the sale of assets in an S corporation. If the sale is of a California S corporation's assets, then the gain will be sourced to California.

***Example of S corporation sale***

Lenny's Cement Inc. is a California S corporation. Leo is the sole shareholder and his basis in the corporation is $1,000. The corporation's basis in the assets is $0. Lenny's Inc. does all its business in California. Leo wants to sell his business and move to Nevada, where he won't be stuck with California's high taxes.

Lenny's Inc. sold the corporate assets to Vito's Cement, LLC for $500,000 on January 2. Vito, the managing member, does not want to buy the stock because he wants to depreciate the purchase of those assets. Lenny's Inc. had no other income in that year. Leo dissolves the corporation on July 1.

Lenny's Inc. will owe the 1.5% tax on the $500,000 gain ($500,000 sales price minus $0 basis) on the sale of the assets. The $500,000 gain will pass to Leo and will be taxable to California whether Leo is a resident or not because the gain is from the sale of the California assets.

If Leo is a resident of California, he will have capital loss on the dissolution of the corporation. The loss is computed as follows:

| | |
|---|---|
| **Basis** | |
| Original basis | $ 1,000 |
| Income reported in 2017 | 500,000 |
| Leo's basis | $501,000 |
| **Cash received** | |
| Cash from sale | $500,000 |
| Less California tax paid | ( 7,500) |
| Cash received from sale | $492,500 |
| **Gain/loss on distribution** | |
| Basis | $501,000 |
| Less cash received | ( 492,500) |
| Loss on dissolution | $ 8,500 |

If Leo is a California resident, he will report the loss. If he is a nonresident, the loss on the sale of stock is not deductible for California purposes, as it is an intangible.

This generally precludes S corporation sales since they are almost always sales of assets. If an S corporation sells its assets, the gains will flow through to the shareholder as taxable to California regardless of the shareholder's state of residence.

If a C corporation sells its assets, the gains will be taxable to the corporation, but the nonresident shareholder will not pay California tax on the liquidation of the corporation and distribution of the assets.

***Example of selling C corporation stock***

Jim owns 100% of the stock in the Blast Off Bar, a California C corporation. Jim sells the stock in Blast Off for $500,000. His basis is $1,000.

If Jim sells the stock while a resident, he will be subject to California tax on the $499,000 gain.

If he instead becomes a nonresident and then negotiates and sells the stock in Blast Off, his gain on the sale is not subject to California tax.

## When did the sale happen?

To qualify, the sale must take place after the taxpayer establishes residency in another state.

This can bring up the question of when a sale takes place and the FTB may assert that the actual sale took place before the escrow closing date if all of the incidences of a sale are in place (that is, if there is a meeting of the minds). (***Comm. v. Court Holding Co.*** (1945) 324 U.S. 331) A taxpayer should move to the nontax state before even beginning the process of looking for a buyer.

> ***Example of negotiating a sale prior to moving***
>
> Diane wants to sell all of the stock in her 100%-owned campaign management company, Campaigns R Us, Inc., and retire to Las Vegas.
>
> On February 1, she verbally agrees with Barbara to sell the company at a certain price with certain other terms, including that the transfer will take place on August 1. She moves to Las Vegas on May 1 and severs all ties with California, clearly establishing Nevada residency.
>
> The FTB will likely successfully argue that the sale actually took place on February 1 when there was clear agreement on the terms of the sale (i.e., a clear meeting of the minds).

Finally, a taxpayer should be very wary of structuring the transaction as an installment sale. 18 Cal. Code. Regs. §17952 states that California will tax a nonresident on installment gain from the sale of an intangible asset sold while a resident.

# THE AUDIT PROCESS

When a taxpayer files a part-year resident return with a large amount of income received after the change of residence, the FTB will often begin the audit process. Among other ways, the FTB finds prior residents claiming to be nonresidents through:

- A part-year resident return with a large amount of income after the residency change;
- Newspaper articles reporting large court wins (such as the ***Hyatt*** case, where the newspapers reported Hyatt's large patent settlement);
- W-2s that report income as California-source, but the taxpayer is excluding the income; or
- Informants (ex-spouse, former employees, etc.)

### Before the audit begins

Months before the taxpayer is aware of the audit, the FTB is combing through multiple databases to investigate:

- Bank accounts in California and other states;
- Where wage and 1099 income was reported;
- Property owned in California and other states;
- Returns filed in other states;
- Where the taxpayer has driver's licenses, business licenses, or professional licenses;
- Other business entities or trusts owned by the taxpayer that may be operating in or own property in California;
- When the taxpayer obtained a new driver's license;
- If and when property was purchased in the other state; and
- Where the taxpayer claimed the homeowner's exemption.

It is also possible that the auditor will have visited Facebook, LinkedIn, Instagram, and generally searched the web for information about the taxpayer. Remember, we all love digging for dirt about people on the web, and the FTB is looking for tax pay dirt. They will likely also have credit and other information available on paid websites like Spokeo.

Using this information, the FTB will determine whether to embark on an audit.

Once the residency audit begins, the FTB will request:

- Credit card statements/receipts;
- Airline and other travel verification;
- Bank statements, including ATM and debit transactions; and
- Utility bills.

## Change of residency audit

One of the first things the FTB will do — particularly if the taxpayer still has property (or lots of family) in California — is to determine the number of days the taxpayer spent in California versus the number of days spent in the new state.

When comparing time in California versus time in the new resident state, the FTB ignores time spent in other states and countries. The taxpayer's goal is to spend few days in California and many days in the new resident state.

The ***Appeal of James and Kathryn McMenamin*** ((November 1, 1999) SBE-98A-1150) demonstrates the problems faced by retirees who have family in California and spend their retirement years traveling while retaining ties with California. In this case, the taxpayers claimed to be residents of Nevada in 1986–1988 and Washington in 1989.

Using credit card statements and receipts, checks, bank statements, and third-party contacts, the FTB placed the McMenamins in California more than in any other state.

The McMenamins' attorney pointed out that some of the days the FTB placed the taxpayers in California the taxpayers were out of the country, or there was conflicting evidence that the taxpayers were actually in Nevada. However, note in the chart below that the number of days spent in California is higher than anywhere else.

| **Days Spent in Various States** | | | | | | |
|---|---|---|---|---|---|---|
| **Year** | **California** | **Nevada** | **Washington** | **Other** | **Unknown** | **Total** |
| 1986 | 146 | 8½ | | 23½ | 187 | 365 |
| 1987 | 176 | 12½ | | 38½ | 138 | 365 |
| 1988 | 170½ | 6½ | | 11½ / 13½ | 164 | 366 |
| 1989 | 178 | | 38 | 58 | 91 | 365 |

## What should clients do?

Here's our recommendation to avoid a change-of-residency train wreck:

1. Plan the move to the other state and truly sever the ties with California. Do not plan to return to California in the next few years at least;
2. Document all issues that point to the date of residency change on the date you will enter on the tax return. Keep this documentation for at least five years, and more if the taxpayer moves back to California within the five-year period;
3. Provide your client with a written list of do's and don'ts:
    a. Do not keep a car registered in California;
    b. Do not spend a lot of time either working, visiting, or conducting personal business in California after the move;
    c. Do file all required tax returns in the new state; and
    d. Do buy a home in the new state and move the furniture to that home on or before the stated move date.
4. Alert your client that, in the case of an audit, the FTB will look at copies of bank and credit card transactions, employment records, and utility bills, if a home is kept in California; and
5. Remember, if it looks like the taxpayer moving for the sole reason of avoiding California tax, your client will likely lose the residency audit.

***Example of taxpayer still a resident***

Sam and Sandy retire and move to Texas. They want to keep their California home because it has been in the family for years. Without a property manager, they lease the property to their children. They buy a large home in San Antonio and move there on July 1, and begin selling stock in August of the same year, generating $250,000 in capital gains after they moved.

The FTB will likely assert that they are residents of California because they also:

- Return to California periodically to see doctors and dentists;
- Remain members of and make contributions to their California church;
- Rent the house to their children;
- Are managing members of a California LLC; and
- Sandy continues to work as a consultant for her former employer and although she does most of her work from her home, she comes to California periodically.

As a result, Sam and Sandy can look forward to a residency audit.

***Example of becoming nonresidents***

Jim and June retire and move to Idaho. They keep their California home because it has been in the family for years. They employ a property manager to lease the property. They buy a large home in Coeur d'Alene and move there on July 1 and begin selling stock in August of the same year generating $250,000 in capital gains after they moved.

Although they kept their California home, when they are audited, the FTB will likely agree they are nonresidents of California because they also:

- Leased their home for one year at fair market value to an unrelated party;
- Immediately rewrote their trusts and wills using an Idaho attorney;
- Found new physicians, dentists, and an estate attorney in Idaho;
- June did consulting work for a company in Idaho and Jim got a job in Idaho;
- Took out driver's licenses in Idaho and turned in their California driver's licenses;
- Joined a new church in Idaho;
- Voted in Idaho;
- Did not return to California in the two years following the move for visits or business; and
- Filed an Idaho resident return reporting all income earned from July 2 through the end of the year.

## You may have to be the bad guy

Clients don't want to accept the fact that selling the house can be pivotal. They will give you all the emotional, financial, and logical reasons why they should keep the house.

They will tell you they are leasing the house on a long-term lease. If they aren't entirely truthful, they will lose. If they change their minds a year or two into the move and either come back, or let family members use the house, they will lose the audit.

When advising your clients and preparing them for a domicile change, dig deep into their plans. Only then can you advise them as to what they must do if they really want to change residence. Make the break as clean and visible as possible. Because even if you win the inevitable residency audit, the cost to you and your clients will eat into the tax savings.

## Recommendations

Eric Coffill (ericcoffill@eversheds-sutherland.com) is a nonresident expert and Senior Counsel at Eversheds Sutherland (US) LLP. From his experience in residency audits, appeals, and court battles, Eric recommends the following:

- You must break meaningful ties with California. It is not enough to build ties with another state if the California ties remain;
- You must build solid new ties with another state that are, at a minimum, comparable to the ties you had in California. It is not enough to break California ties if you do not reestablish yourself permanently somewhere else. Don't establish new ties spread among multiple states. The analysis is going to be California versus a single new state in a residency and domicile audit by FTB;
- The times you do return to California need a solid case for being for a temporary/transitory purpose;

- Carefully consider and understand source income issues, because a change of residency will not solve your California-source income problems. For instance, if you have a truckload of vested stock options, moving out of California is not going to move the California tax needle as much as you think;
- Dealing in intangibles is fine, e.g., stock (versus assets), as long as you think through any business situs exception problems (which would tie those intangibles back to California);
- If it is a big dollar issue, expect to be audited by the FTB and plan accordingly. If it does not happen, so much the better; and
- It is one thing to move out of California and change your residency/domicile. It is another to move before/by a specific date (e.g., the big sale). The FTB agreeing that you moved, but moved two months after the big realization event, is not much of a victory.

### A 2021 case illustrates this concept

In the *Appeal of Bracamonte* (2021-OTA-156P (pending precedential)), the taxpayers lost an almost $1.7 million residency appeal for the 2008 tax year when they started a move in February, sold highly appreciated stock in their closely held corporation, Jimsair, Inc., on July 18, but didn't take possession of their new Nevada home until September 22 of that year.

The taxpayers made the grave error of believing that all they had to do was meet a number of the **Bragg** factors and they would be nonresidents, including:

- Renting an apartment in Nevada;
- Buying and registering vehicles in Nevada and having a vehicle serviced in Nevada;
- Changing their address to a Nevada P.O. box — with the option to have their mail forwarded, which under Bragg probably doesn't point to a change in residency and domicile;
- Opening a Nevada checking account;
- Paying a Nevada attorney to change their trust to a Nevada trust; and
- Registering to vote in Nevada.

The OTA ruled that, despite their purported intent to change their California domicile, the taxpayers did not "adopt some other permanent home" when they took possession of their rented apartment in Henderson, Nevada. Rather, their possession of their apartment was marked with impermanence. The taxpayers rented the apartment in Henderson, Nevada, on March 6, 2008, because, as the taxpayer-husband testified at the oral hearing, they "needed a temporary place to live."

They testified that, as they looked for a permanent home, they decided to secure an apartment in the area of their desired future home to make purchasing a home easier.

The taxpayers eventually purchased a home in September 2008, but until then they:

- Retained their large California home;
- Left much of their personal property at their California home;
- Retained significant and continuing contacts with California, including purchasing and registering a motorcycle in California in June 2008 (although the taxpayers did begin to increase contacts with Nevada);
- Worked with California attorneys regarding pending litigation and the sale of their company as well as running the business; and
- Spent a majority of their time in California from February 25, 2008, through July 18, 2008 (between March 6, 2008, when the taxpayers took possession of their apartment, to September 2008, they stayed in California an average of 8.5 days at a time. The taxpayers' stays in Nevada averaged just 2.18 days).

The taxpayers testified that they only took essentials to their Nevada apartment, such as linens, towels, dishes and some basic furniture. Notably, they left their precious mementos and other valuable items in California until they acquired a "permanent home" in Nevada.

The OTA ruled that the taxpayers' possession of a rental apartment was part of their plan to find a permanent home but was not the actual move to a new residence with the intent to remain there permanently.

Consequently, because these and other factors favored California residency, the OTA ruled that the taxpayers retained their California domicile through July 18, 2008, and did not change their "permanent home" when they took possession of their apartment.

***Comment***

Although not mentioned in the appeal, as part of the Jimsair sale to Landmark Aviation, the taxpayer-husband agreed to "staying on until Landmark hires a new manager." This could be a further indication that the taxpayer had not changed domicile until after the July 18 sale.

### 2009 year

Although it was stipulated that the taxpayer was a resident of Nevada in 2009, because the stock was sold on an installment sale in 2008, the final payment in 2009 was taxable to California because the sale of an intangible while a resident is taxable to a nonresident if payments are made during the period of nonresidency. (18 Cal. Code Regs. §17952)

***Resources***

See Spidell's "Checklist to help determine California residency/nonresidency" on page 85, which includes the ***Bragg*** factors.

See page 34 for more information on the sale of intangibles by a nonresident.

***Tips for a residency audit***

**Don't show up without records:** A taxpayer who requested a residency appeal produced only a W-2 and two months of bank statements as evidence that he was a nonresident for the two months at issue. The Board ruled that the taxpayer failed to show that his time in Texas was for more than a temporary and transitory purpose, so therefore all of the wages he earned while in Texas were subject to California tax. (***Appeal of Scott Larson*** (June 14, 2016; released September 18, 2017) Cal. St. Bd. of Equal., Case No. 7966921)

**Don't amend a return and say you're a nonresident:** After filing a Form 540 resident return, the taxpayers filed a 540NR, nonresident return and requested a $9,719 refund stating that the husband was a nonresident of California. After the FTB audited the return, they disallowed the refund, and the Board agreed that the taxpayer was a resident for the year at issue. (***Appeal of Hoog*** (August 30, 2016; released October 3, 2017) Cal. St. Bd. of Equal., Case No. 819085)

## COMMUNITY PROPERTY

Community property is all of the property that is not separate property acquired by a husband or wife, or both, while domiciled in a community property state. Each spouse owns one-half of all community property.

Marital property rights in personal property are determined by the law of the domicile of the acquiring spouse. See the following table.

| **Community Property States and U.S. Territories** | |
|---|---|
| Alaska (see note below) | New Mexico |
| Arizona | Texas |
| California | Washington |
| Idaho | Wisconsin |
| Louisiana | Puerto Rico |
| Nevada | Commonwealth of Northern Marianna Islands |
| **Note:** Although Alaska is not a "community property state," it allows a married couple to form community property agreements or trusts. These agreements and trusts allow spouses to identify what property and income is to be classified as community property. | |

***Comment***

The community property concept applies to income earned by residents domiciled in foreign countries as well.

## COMMUNITY INCOME

Income generated from community property is community income. Unless a valid separate property agreement is in effect, community income also includes compensation for services if the spouse earning the compensation is domiciled in a community property state. In California, acquired community income is income that is earned by either spouse through personal services or property that is acquired with community funds. In California, property that is acquired during the marriage by gift or inheritance is not community property, although it can become community property by actions of the spouse who receives the property. Couples may have a prenuptial agreement or a written postnuptial separate-property agreement that sets forth what income and/or property is community or separate property.

The domicile of the taxpayer determines whether income is community or separate property. Thus, a taxpayer who is a nonresident under R&TC §17014(d) is still domiciled in California and one-half of his wages are taxable to the resident spouse.

***Example of taxpayer nonresident's community income***

Jack and his wife Patty live in California. Jack signs a two-year contract to perform services in Saudi Arabia. Patty stays in California with the children. Jack meets the definition of nonresident under R&TC §17014(d). However, because he is still domiciled in California, one-half of his wages are taxable to Patty because she is a resident of California.

## Cases

Where a wife was a resident of California, but her husband was a resident and domiciled in another state, the status of the husband's earnings as community or separate was determined by the laws of the other state. To the extent the other state considered these earnings as community property, California required the wife to report them on her separate California return. (***Appeal of Herrman*** (August 6, 1962) 62-SBE-041)

Although it is not necessary to have filed for separation or divorce, you may have a difficult time convincing the FTB that your client was indeed "living separate and apart" from the spouse. In ***Appeal of Jack A. and Susan S. McLeod*** ((May 4, 1995) Cal. St. Bd. of Equal., Case No. 92A-0672), the Board ruled that the taxpayers' income and deductions were still community property even though they lived apart for eight years, because, among other things:

- They owned a home together in California;
- Mrs. McLeod traveled with her husband and was a homemaker during the appeal years;
- Mr. McLeod worked for his employer out of his home in Rancho Bernardo, California, during portions of the years at issue;
- Mr. McLeod had a telephone in their California residence listed under his name;
- Mr. McLeod's withholding statements for the appeal years listed the California address as his home;
- The McLeods filed joint returns rather than separate returns for the appeal years; and
- The McLeods provided no evidence they had ever legally separated or divorced.

# RESIDENT WITH NONRESIDENT SPOUSE

## FILING STATUS

California taxpayers generally must use the same filing status as was used on the federal return. A husband and wife who file a joint federal income tax return must file a joint California income tax return, except when either spouse was:

- An active member of the armed forces or any auxiliary branch thereof during the taxable year; or
- A nonresident of California for the entire taxable year and had no income from a California source during the taxable year.

In these cases, the taxpayers may either file a joint or a separate California return. (R&TC §18521) If the taxpayers file separately, they may use the married filing separate status or, if qualified, HOH status.

If taxpayers file separate California returns and a joint federal return, calculate the amount of federal adjusted gross income to enter on the separate California returns by using federal instructions for the married filing separate status (as if the taxpayer had used that status for federal) and attach a copy of the federal return (as filed) to the California return.

A taxpayer may amend a return from joint to separate if R&TC §18521 allows a separate filing status for California and joint filing status for federal.

## DOMICILE FOR NONRESIDENT SPOUSE

An interesting problem can develop for couples when one spouse is domiciled in California and the other spouse is a resident of and domiciled in another state. The nonresident spouse would presumably have California-source income because one-half of the California-source income of the resident would be attributed to the nonresident spouse. In this situation, the couple must file a joint return because the nonresident spouse would have California-source income.

However, if the spouses are domiciled in a separate-property state and one spouse has income from California sources but the other spouse does not, the spouse with the California-source income may file a separate California return.

***Example of nonresidents domiciled in a separate property state***

Jack and Jill are residents and domiciliaries of Montana, a separate-property state. Jack owns a California rental property. Jill has no ownership interest in the property. They have no other California-source income. Jack may file a separate California nonresident return.

A California resident's taxable income included 50% of the income her husband earned while a resident of Arizona, because that income was community property. (***Appeal of Karavakis*** (February 23, 2010) Cal. St. Bd. of Equal., Case No. 478167) The following example shows how these returns must be filed.

***Example of a nonresident spouse domiciled in a community property state***

In Year 1, Al B. Gone was laid off from his job at Dotcomorbust and was unable to find further employment in California. He accepted a job with Sandnosurf in Arizona, a community-property state. In late Year 1, he moved permanently to Phoenix, where he had some separate property and a separate property savings account. However, his wife, Truly, decided to stay in California until she was eligible for retirement in two or three years, at which time she planned to join Al in Arizona. Al is domiciled in Arizona because he does not intend to return to California. Truly is domiciled in California.

In Year 2, the Gones had income from various sources taxable to California, and, therefore, reported on their California Form 540NR, as follows:

| | | | | | |
|---|---|---|---|---|---|
| Truly's wages | $40,000 | × | 100% | = | $40,000 |
| Al's wages | $50,000 | × | 50% | = | $25,000 |
| Interest from joint account in California | $1,000 | × | 50% | = | $ 500 |
| Interest from joint account in Arizona | $500 | × | 50% | = | $ 250 |
| Interest from Al's separate Arizona account | $800 | × | 0% | = | $ 0 |
| Loss from California real property | ($2,000) | × | 100% | = | ($ 2,000) |
| Income from Al's separate Arizona real property | $1,000 | × | 0% | = | $ 0 |
| Income from joint California partnership | $3,000 | × | 100% | = | $ 3,000 |
| Income from jointly-owned stock | $5,000 | × | 50% | = | $ 2,500 |
| Income taxable by California | | | | | $69,250 |

***Example of a nonresident spouse domiciled in a separate property state***

Assume the same as above except Al accepted a job with Skinosurf in Utah, a separate-property state. In late Year 1, he moved permanently to Salt Lake City. In Year 2, the Gones had income from various sources reported on their California Form 540NR as follows:

| | | | | | |
|---|---|---|---|---|---|
| Truly's wages | $40,000 | × | 100% | = | $40,000 |
| Al's wages | $50,000 | × | 0% | = | $ 0 |
| Interest from joint account in California | $1,000 | × | 50% | = | $ 500 |
| Interest from joint account in Utah | $500 | × | 50% | = | $ 250 |
| Interest from Al's separate Utah account | $800 | × | 0% | = | $ 0 |
| Loss from California real property | ($2,000) | × | 100% | = | ($ 2,000) |
| Income from Al's separate Utah real property | $1,000 | × | 0% | = | $ 0 |
| Income from joint California partnership | $3,000 | × | 100% | = | $ 3,000 |
| Income from jointly-owned stock | $5,000 | × | 50% | = | $ 2,500 |
| Income taxable by California | | | | | $44,250 |

See "How to split income on Form 540NR" on page 80 and "Income taxability chart for resident taxpayer with nonresident spouse" on page 81.

## REPORTING INCOME AND CHANGE OF RESIDENCY

R&TC §17041 requires a taxpayer who changes from nonresident to resident status to restate carryover items, deferred income, suspended losses, and suspended deductions as if the taxpayer had always been a resident.

A part-year resident must compute income and deductions using residency rules for the period of the year the taxpayer was a California resident, and nonresidency rules for the period of the year the taxpayer was a nonresident. Compute any prior-year carryover loss as if the taxpayer were a California resident for all prior years (or as if the taxpayer were a nonresident for all prior years). Prorate both capital loss carryover amounts based upon the period of California residency and the period of nonresidency during the year. (FTB Publication 1100, Taxation of Nonresidents and Individuals Who Change Residency)

Items affected include:

- Wages, installment sales, and other income accrued prior to change in residency;
- Capital loss carryovers;
- Suspended passive loss carryovers;
- Investment interest expense carryovers; and
- Net operating loss carryovers.

***Comment***

A resident is taxable to California on **all** income from **all** sources if received while the taxpayer is a resident. While this concept seems easy, the difficulty arises when a taxpayer changes residency status.

## PART-YEAR RESIDENT

A part-year resident computes income and deductions using nonresidency rules for the period the taxpayer was a nonresident and using the residency rules for the period the taxpayer was a resident.

## NONRESIDENT TO RESIDENT

When a taxpayer becomes a resident, the taxpayer must recompute all carryover items as if he or she had been a resident for all prior years.

## RESIDENT TO NONRESIDENT

When a taxpayer becomes a nonresident, the taxpayer must recompute all carryover items as if he or she had been a nonresident for all prior years.

***Example of carryover items***

Tom is a resident of Texas in Year 1. He has a net capital loss carryover to Year 2 of $10,000 on the sale of some of his dot-com stock. He moves to California on January 1, Year 2, and sells his bank stock on January 2, Year 2, at a gain of $5,000. Because Tom is a California resident when he sells his bank stock, we look at his capital loss carryover as if he had been a resident for all prior years and he may use the $10,000 capital loss carryover to offset his Year 2 California gain. His Year 2 net capital loss is $5,000. He uses $3,000 and his carryover to Year 3 is $2,000.

| | Federal | California (resident) | California (nonresident) |
|---|---|---|---|
| **Year 1** | ($13,000) | ($13,000) | $0 |
| Used | 3,000 | 3,000 | 0 |
| Carryover to Year 2 | ( 10,000) | ( 10,000) | 0 |
| **Year 2** | 5,000 | 5,000 | 0 |
| Net | ( 5,000) | ( 5,000) | 0 |
| Used | 3,000 | 3,000 | 0 |
| Carryover to Year 3 | ( 2,000) | ( 2,000) | 0 |
| **Year 3 gain** | 4,000 | | $4,000 |
| Taxable | 2,000 | | $4,000 |

# COMPUTATION OF TAXABLE INCOME

## WAGES

Residents are taxed on all income regardless of source. California taxes compensation received by a resident that accrued before the taxpayer became a California resident.

***Example of salary earned prior to residence***

Lefty O'Soon lived and worked in New York until April 30. He permanently moved to California on May 1 of the same year. His former New York employer pays its employees on the fifth of every month. On May 5, Lefty's last paycheck of $3,000 was deposited by his employer into his checking account. California taxes the compensation of $3,000 because Lefty was a California resident when he received the income. If he also paid tax to New York on this compensation, he is allowed a credit for taxes paid.

When a resident leaves California and collects wages earned in California, California taxes those wages because they were earned from personal services performed in California.

***Example of fully taxable wages***

May Bee is a California resident who worked at a store in Los Angeles. She permanently moved to Nevada on May 1. Her former California employer pays its employees on the fifth of every month. On May 5 of the same year, May's employer mailed her last paycheck of $1,000 to her in Nevada. California taxes the $1,000 of wages because it is compensation for services performed in California.

However, when determining the amount taxable to California, we count only wages paid for services rendered in California. Thus, if a taxpayer performed services outside of California, the income is not taxed to the taxpayer who becomes a nonresident.

***Example of partially taxable wages***

Spring Around is a business consultant who is a resident of California but who spends half of her time in Phoenix at her clients' businesses. Spring permanently moves to Phoenix on April 30. Her California employer pays its employees on the fifth of every month. On May 5 of the same year, Spring's employer deposits her last paycheck for her April wages into her checking account. California taxes the compensation of services performed in California. During the month of April, Spring spent one-half of her work days in California and one-half of her work days in Arizona. Thus, California taxes $1,500 ($3,000 × 50%) of her pay. If Arizona also taxes these wages, she is allowed a credit for taxes paid.

# STOCK OPTIONS

## Nonqualified stock options

### Moving into California

When a taxpayer is granted a nonqualified stock option (NQSO) while a nonresident of California and later exercises it while a California resident, California taxes the difference between the FMV of the stock on the date of exercise and the exercise price. (***Appeal of Gene L. Clothier*** (June 30, 2000) Cal. St. Bd. of Equal., Case No. 27809)

### Moving out of California

When a taxpayer is granted an NQSO while a California resident and later exercises it while a nonresident, the income from its exercise is compensation for services with a source in California,

the state where the taxpayer performed the services. (***Appeal of Charles W. and Mary D. Perelle*** (December 17, 1958) 58-SBE-057)

Although the regulations do not directly address stock options, where the taxpayer performed services both within and outside of California, allocate to California only that portion of total compensation reasonably attributed to services performed in California. (18 Cal Code Regs. §§17951–17955) One reasonable method is an allocation based on time.

In ***Appeal of Richard R. and Mari J. Cower*** ((September 15, 2005) Cal. St. Bd. of Equal., Case No. 294394), the taxpayer was granted NQSOs while employed in California. He became a nonresident of California when he moved to Idaho in March 2000. The Board ruled that the proportion of the total income equal to the ratio of California work days (862) to total work days (1,126) is California-source income.

The computation of income taxable to California is computed by multiplying the allocation ratio by the total stock option income taxable for federal purposes:

$$\frac{\text{California work days from date of grant to date of exercise}}{\text{Total work days from date of grant to date of exercise}} = \text{Allocation ratio}$$

$$\text{Allocation ratio} \times \text{Total stock option income} = \text{Income taxable by California}$$

This ratio applies only to options exercised after the taxpayer becomes a nonresident. If a taxpayer exercises an option while a resident, the full amount of income is taxable to California even if some services were performed in another state.

### Year-of-exercise rule

In 2006, the New York Tribunal instead applied a rule that looks solely to the "year-of-exercise," sourcing to the days worked for an employer only in the year that the nonresident receives the income. Under this rule, a nonresident pays New York tax only to the extent that he or she worked in New York during the year the stock options were exercised. (***In the Matter of E. Randall Stuckless*** (August 17, 2006) State of New York Tax Appeals Tribunal, DTA No. 819319) It could be argued that the same applies to California, as the California regulations do not specifically call for the above-mentioned allocation as it pertains to stock options.

> ***Comment***
>
> This would be an aggressive, but potentially successful, position. We are not aware of a taxpayer who tried this strategy.

The IRS issued final regulations in 2005 that provide for an allocation based on a day count from the grant date to the vesting date (grant-to-vesting method). (Treas. Regs. §1.861-4(b)(2)(ii)(F)) Spidell believes a taxpayer could argue that this allocation method is reasonable under 18 Cal. Code Regs. §17951-5(b). Even though California does not specifically conform to IRC §861 and the regulations thereunder, a taxpayer may turn to the federal rules for guidance on a reasonable allocation method.

### Nonqualified stock option income sourced from date specified in agreement

A taxpayer was liable for California tax on gain from the sale of stock options, measured from the grant date specified in the stock option agreement, which was two years prior to the time the taxpayer moved to Nevada, until the date the option was exercised. (***Appeal of Sullivan*** (February 26, 2014) Cal. St. Bd. of Equal., Case No. 610943)

The taxpayer claimed that pursuant to IRC §409A, the "grant date" was the date the number of shares granted to the taxpayer could actually be known, which was after he moved to Nevada.

However, IRC §409A was not the controlling statute for determining the grant date. Income from a nonqualified stock option is sourced to California based on the number of California work days to overall work days from the time the stock option was granted until it was exercised.

### Taxpayer win: value at date of residency change

After the Board ruled in favor of the taxpayers on their residency case, the FTB unsuccessfully attacked the taxpayer's method of computing the taxable portion of the exercise of an NQSO. (***Appeal of James F. and Diane Montgomery*** (August 21, 2008) Cal. St. Bd. of Equal., Case No. 309423)

The taxpayers attributed the appreciation in stock values through December 31, 1995, the date they changed their domicile, to California; they attributed appreciation after December 31, 1995, to Nevada. (Most of the appreciation occurred during the spring and summer of 1997.)

The Board noted that the FTB did not bring up the method used to allocate the option income in a timely manner and that it would be difficult, if not impossible, to determine work days in California versus outside of California because the taxpayer traveled extensively for work during the years between the grant date and his exercise of the options.

It was pointed out that the ratio would be close to the one used by the taxpayers and that it would be difficult if not impossible to gather information that would be 11 to 22 years old.

This decision shows that the Board will consider other reasonable allocation methods. However, this decision is also "not to be cited as precedent" so another taxpayer may not use it as support. Although it opens the door to other allocation methods, the FTB waited until the appeal to bring the issue up, which shifts the burden of proof from the taxpayer to the FTB; in this case it appears that either method — the FTB's or the taxpayer's — would bring about a similar result.

## Employee stock purchase plans

### Moving into California

A taxpayer who acquires employee stock purchase plan (ESPP) shares while a nonresident and then sells the shares after becoming a California resident will be taxed by California on the difference between the amount realized on the sale and the exercise price. California will tax both the ordinary income and the capital gains because the taxpayer is a California resident when the stock is sold.

### Moving out of California

When a taxpayer exercises an ESPP while a resident of California and later sells the stock after becoming a nonresident, California will tax the ordinary income element because the services the taxpayer performed to earn the income were rendered in California. This interpretation follows the Clothier case, which determined that taxpayers who exercised non-statutory options after becoming nonresidents were subject to California tax. (***Appeal of Gene L. Clothier*** (June 30, 2000) Cal. St. Bd. of Equal., Case No. 27809) Any further gain on the sale of the ESPP shares, however, should be taxed as capital gains to the state of residence.

## Incentive stock options

### Nonresidents not taxed on ISO income

The FTB will treat the capital gain portion of a nonresident's incentive stock option (ISO) exercise as intangible income taxed to the state of residence. This means that a taxpayer who is granted an ISO while a resident of California but exercises it and disposes of it in a qualifying disposition while a nonresident will not be taxed to California on the capital gain portion.

If, however, the taxpayer disposes of the stock in a disqualifying disposition, the wage income is taxable to California using the rules applicable to nonqualifying dispositions (as discussed above).

By taking this position, the FTB will not follow the ***Michaelsen*** decision, a New York case that allowed the state to tax a nonresident on the capital gain portion of the ISO disposition, even though capital gains are intangibles. (***Michaelsen v. The New York State Tax Commission*** (July 8, 1986) New York Court of Appeals, 196 NYLJ No. 108)

### AMT treatment

For AMT purposes, ISOs are treated the same as NQSOs. The spread income is taxable as compensation at the time of exercise. (IRC §422) Because California conforms to federal law, the AMT wage portion is taxable to California at exercise using the proration formula for NQSOs.

***Example of a qualifying disposition***

Ben Moved was granted an option to exercise 1,000 shares of ABC stock on January 10 of Year 1 while he was a resident of California. The fair market value of the shares was $1 per share. He was transferred to Texas on July 10 of Year 1. He exercised the options on January 10 of Year 3, when the FMV of the shares was $50 per share. He sold the shares on December 10 of Year 4 for $100 per share.

Because he held the shares more than two years from the grant date and more than one year from the exercise date, the entire gain is capital gain and Ben, a Texas resident, pays no California tax.

Assume, instead that Ben sold the shares on January 1 of Year 4, less than one year from the exercise date. Ben is taxable to California on:

$$\frac{\text{185 (number of CA work days from date of grant to date of exercise)}}{\text{365 (total number of work days from date of grant to date of exercise)}} \times \$49{,}000 = \$24{,}299$$

## Restricted stock options

Chief Counsel Ruling 2014-01 addresses how income from stock issued to a taxpayer under a restricted stock unit (RSU) plan should be treated when the RSU is granted to a taxpayer:

- When he is a resident but did not recognize the income until he became a nonresident; and
- When he is a nonresident, but he performed services for the employer in California before the RSUs vested.

A taxpayer must use a "reasonable allocation method" to determine the portion of California-source income received.

In the scenarios addressed in the ruling, the most reasonable method to determine the portion of California-source income received is to multiply the compensation received by a ratio of working days in California from the grant date to the vest date over the total working days during the same period.

A California resident is taxed on all income from the option no matter where the compensation was received.

### Taxpayer's "annual stock appreciation method" no good

The OTA ruled that a taxpayer who received RSUs while employed by Facebook was liable for tax based on the FTB's method of computing days worked in California. (**Appeal of Prince**, 2021-OTA-088)

The FTB auditor used the working days method to allocate RSU income to California. This method multiplied the taxpayer's total income from each of the RSUs by the ratio of his California workdays from the grant date to the vesting date, over the total number of workdays during that period.

The taxpayer argued that this method was unfair because Facebook stock skyrocketed in value after he left California, increasing from $7.27 per share to $28.00 per share during the 2012 tax year when vesting occurred.

Instead, the taxpayer proposed his "annual stock appreciation method," under which the income attributable to his compensation for personal services in California would equal the value of the stock on his last day of work in California ($7.27 per share) minus the price of the stock on the date of the grant.

The OTA did not accept the taxpayer's method because to allocate income based on a comparable stock price on a specific date during the vesting period, without evidentiary support beyond the fact that the stock rose sharply after that date, was inherently arbitrary.

However, the FTB's working days formula accounts for the even growth in value recognized upon the vesting date across the entire duration of the services provided.

Compensation for personal services performed both inside and outside California, including compensation in the form of RSUs, is allocated between California and other states and foreign countries. The portion of the total compensation which is attributable to personal services performed in California is allocated to California, although the regulations do not prescribe any specific method for making this allocation.

# TABLE OF TAXATION OF STOCK OPTIONS

| Table of Taxation of Stock Options | | |
|---|---|---|
| **Type of stock option** | **If you are a California resident…** | **If you are a California nonresident…** |
| **Nonstatutory stock option (NSO)** | …on the date you exercise your NSO:<br>• Wage income is taxable by CA; and<br>• Possible Other State Tax Credit. | …on the date you exercise your NSO:<br>• Wage income is taxable by CA to the extent you performed services in CA from the grant date to the exercise date; and<br>• Possible Other State Tax Credit. |
| | …on the date you sell the stock:<br>• Capital gain is taxable by CA. | …on the date you sell the stock:<br>• Capital gain is not taxable by CA. |
| **Incentive stock option (ISO)** | …on the date you exercise your ISO:<br>• AMT adjustment is made if you do not sell the stock in the year of exercise; and<br>• Increase your AMT basis by the AMT adjustment. | …on the date you exercise your ISO:<br>• AMT adjustment is made if you do not sell the stock in the year of exercise;<br>• AMT adjustment is included to the extent you performed services in CA from the grant date to the exercise date; and<br>• Increase your AMT basis by the AMT adjustment. |
| | …on the date you sell the stock in a qualifying disposition at a gain:<br>• Capital gain is taxable by CA; and<br>• Possible AMT credit. | …on the date you sell the stock in a qualifying disposition at a gain:<br>• Capital gain is not taxable by CA; and<br>• Possible AMT credit. |
| | …on the date you sell the stock in a disqualifying disposition:<br>• Wage income and capital gain (if any) are taxable by CA;<br>• Possible Other State Tax Credit; and<br>• Possible AMT credit. | …on the date you sell the stock in a disqualifying disposition:<br>• Wage income is taxable by CA to the extent you performed services in CA from the grant date to the exercise date;<br>• Capital gain (if any) is not taxable by CA;<br>• Possible Other State Tax Credit; and<br>• Possible AMT credit. |
| **Employee stock purchase plan (ESPP)** | …on the date you sell the stock in a qualifying or disqualifying disposition at a gain:<br>• Ordinary income and capital gain are taxable by CA; and<br>• Possible Other State Tax Credit. | …on the date you sell the stock in a qualifying or disqualifying disposition at a gain:<br>• Ordinary income is taxable by CA to the extent you performed services in CA from the grant date to the exercise date;<br>• Capital gain (if any) is not taxable by CA; and<br>• Possible Other State Tax Credit. |

*(continued)*

| Table of Taxation of Stock Options *(continued)* | | |
|---|---|---|
| **Type of stock option** | **If you are a California resident…** | **If you are a California nonresident…** |
| **California qualified stock option (CQSO)** | …and R&TC §17502 provisions are met:<br>• Same tax treatment as ISO. | …and R&TC §17502 provisions are met:<br>• Same tax treatment as ISO. |
| | …and R&TC §17502 provisions are not met:<br>• Same tax treatment as NSO. | …and R&TC §17502 provisions are not met:<br>• Same tax treatment as NSO. |
| **Restricted stock option (RSU)** | …on the date the option vests:<br>• Wage income is taxable by CA; and<br>• Possible Other State Tax Credit. | …on the date the option vests:<br>• Wage income is taxable by CA using a reasonable method to allocate based on services performed in California (See Chief Counsel Ruling 2014-01); and<br>• Possible Other State Tax Credit. |
| | …on the date you sell the stock:<br>• Capital gain is taxable by CA. | …on the date you sell the stock:<br>• Capital gain is not taxable by CA. |

# IRA DISTRIBUTIONS

California does not tax the IRA distributions of a nonresident. Taxpayers who move into California are treated as though they were California residents for all prior years for all items of deferred income, which includes IRAs. Accordingly, a taxpayer is allowed a basis for contributions that would not have been allowed under California law had the taxpayer been a California resident.

Taxpayers must determine basis for all years prior to moving to California under California law. For example, if a deduction would have been denied under California law for any prior year, a taxpayer must increase their basis in the IRA by that amount.

Here is the information you will need to calculate the basis:

- How much did the taxpayer contribute each year?
- In each year, 1982 through 1986, was the taxpayer or spouse covered by a qualified pension plan? If the answer is yes, the basis is the total contribution with a maximum of $2,000 per year.
- If neither the taxpayer nor the spouse were covered by a pension plan in years 1982 through 1986, how much was the earned income of the spouse who made the contribution? Multiply the earned income by 15%. The deductible IRA would have been this amount, but not more than $1,500. Thus, the basis is $500 or more for each year they made a $2,000 IRA contribution.
- For IRA contributions in 1987 through 1994, did the taxpayer have earned income computed under California law that was less than the federal allowable contribution? If so, the difference is California basis.
- Was the IRA rolled over from a Keogh or SEP plan from a year prior to 1996? If so, the taxpayer will have a basis equal to the difference between deductible federal and California amounts.
- Was the IRA deduction limited for California purposes because in 2008 and 2009 California did not conform to the federal indexing of AGI for purposes of deducting an IRA?

## Keogh and SEP plans

An individual who contributed to a Keogh or SEP while a nonresident of California has a basis equal to that which he or she would have had if he or she had been a resident during the

contribution years. R&TC §17504 states, "The basis of any person in the employee's trust shall include the amount of any contributions made prior to January 1, 1987, which were not allowed as a deduction under former Sections 17503 and 17513."

### Roth conversions

California conforms to the federal provision allowing a taxpayer to make a Roth conversion. However, due to possible basis differences, the amount taxable on the conversion may be different.

Roth conversion income is taxable to California if the taxpayer was a resident when the conversion was made.

## CAPITAL GAINS

### Sale of stock

The gain on the sale of intangibles is taxable if the taxpayer is a resident on the date of the sale. However, if a resident sells stock or other intangibles in an installment sale and receives payments after becoming a nonresident, the gain is still taxable. (18 Cal. Code Regs. §17952; ***Appeal of Frazar*** (June 16, 2010) Cal. St. Bd. of Equal., Case No. 494349)

## CAPITAL LOSS CARRYOVERS

A taxpayer who is a nonresident does not have a capital loss carryover for California purposes, except to the extent that California-source losses exceed California-source gains. Gains and losses from stock sales are generally intangible and are sourced to the state of residence.

A new resident, however, must recompute capital loss carryover as if he had been a resident during all prior years. A new nonresident must recompute capital loss carryovers and carry over only the excess of losses over income sourced to California.

***Example of taxpayer with capital loss carryover***

Tom is a resident of Texas in Year 1. He had a net capital loss carryover of $10,000 on the sale of some of his dot-com stock. He moves to California on January 1 of Year 2 and sells his bank stock on January 2 of Year 2, at a gain of $5,000. Because Tom is a California resident when he sells his bank stock, look at his capital loss carryover as if he had been a resident for all prior years. He may use the $10,000 capital loss carryover to offset his California gain. His Year 3 net capital loss is $5,000. He uses $3,000 and his carryover to Year 3 is $2,000.

On January 1 of Year 3, Tom moves back to Texas to retire and is now a California nonresident. After he became a nonresident, he sold land in California at a gain of $5,000. Because Tom is now a nonresident, we recompute his capital loss carryover as if he had been a nonresident in all prior years. Because the stock sales from Year 1 did not have a California source, he may not offset the $5,000 gain with the $2,000 capital loss carryover and must pay tax on the $5,000.

### Part-year residents

While it would be convenient if taxpayers changed residency status only on January 1 of a year, in reality this rarely happens.

The part-year resident presents a vexing problem that has been resolved using a two-part process:

1. The carryover to the year that the taxpayer changes residence is prorated for the resident period and nonresident period. The proration is completed in a three-step process; and
2. The carryover to the following year is restated as if the taxpayer had always been a resident or a nonresident, whichever is the year-end status.

***Example of midyear change of residence***

Nathan is a part-year resident for Year 2. He was a resident from July 1, Year 2, through the end of the year. He had the following transactions:

| **Year 1 transactions** | **All sources** | **CA-source** |
|---|---|---|
| Sale of stock | ($8,000) | |
| Sale of land in CA | ($5,000) | ($5,000) |
| | ($13,000) | ($5,000) |
| Used | $3,000 | $3,000 |
| Carryover | ($10,000) | ($2,000) |

| **Year 2 transactions** | **Date** | **Amount** | **Sourced to CA** |
|---|---|---|---|
| Year 1 carryover loss | January 1, Year 2 | ($10,000) | ($2,000) |
| Sale of stock | February 1, Year 1 | $2,000 | No |
| Sale of land in CA | August 1, Year 2 | $5,000 | Yes |
| Sale of stock | September 1, Year 2 | ($8,000) | Yes |

Figure his tax by using the worksheet provided in the Schedule D instructions.

### Part I: Year 2 Loss

**Step 1:** Prorate capital loss carryover amounts based on periods of California residency and nonresidency during Year 2.

| | |
|---|---|
| Year 1 carryover as if a California resident | ($10,000) |
| 184 resident days ÷ 365 days | × 0.5041 |
| Prorated carryover as if a resident | ( 5,041) |
| Year 1 carryover as if a California nonresident | ( 2,000) |
| 181 nonresident days ÷ 365 days | × 0.4959 |
| Prorated carryover as if a nonresident | ($ 992) |

**Step 2:** Carryover to Year 2 allowed.

| | |
|---|---|
| Carryover from period of residency | ($5,041) |
| Carryover from Step 1 | ( 992) |
| Total allowed to offset Year 2 capital gains | ($6,033) |

**Step 3:** Net total capital gains and losses for the period of residency and California-source capital gains and losses for period of nonresidency.

| | |
|---|---|
| Prior to July 1, Year 2 | $ 0 |
| After June 30, Year 2 | 5,000 |
| | ( 8,000) |
| Net | ($3,000) |

*(continued)*

*Example of midyear change of residence (continued)*

**Part II: Carryover of Losses to Year 3**

Compute carryover to Year 2 as if Nathan had always been a resident. If Nathan had been a resident, all gains and losses would have been taxable to California. Thus, his capital loss carryover is:

| | |
|---|---|
| Carryover loss from Year 1 | ($10,000) |
| Sale of stock | 2,000 |
| Sale of land in California | 5,000 |
| Sale of stock | ( 8,000) |
| Total | ($11,000) |
| Used in Year 2 | 3,000 |
| Carryover to Year 3 | ($ 8,000) |

# INSTALLMENT SALES — REAL PROPERTY

Gain on the sale of California real property is taxable to California for all taxpayers regardless of residency.

California taxes installment gains received by a nonresident from the sale of tangible property only if the property is located in California. Real property is taxed based upon where the property is located. Residents are taxed on installment payments received while residents, regardless of the taxpayer's residency status when the sale occurred.

## Always a nonresident

California taxes any gain from the sale to the extent the income from the sale was from a California source.

*Example of nonresident sale of California property*

Ben is a nonresident of California. He sold a California rental property in an installment sale. Ben received installment proceeds comprised of capital gain income and interest income. California taxes the capital gain income because the property was located in California. California does not tax the interest income, which has a source in Ben's state of residence.

## Former California residents

A nonresident is not taxed on installment proceeds received from the sale of property located outside California that was sold while the taxpayer was a resident.

*Example of former resident installment sale*

Jim, while a California resident, sold a parcel of real property located in Washington in an installment sale. On March 1, Jim became an Ohio resident. Three months later, on June 1, he received installment proceeds comprised of capital gain income and interest income. California does not tax Jim's capital gain income received on June 1 because Jim was a nonresident when the payment was received and the property was not located in California.

## California residents — formerly nonresidents

***Example of new resident installment sale***

Sue, while a nonresident of California, sold her Texas rental property in an installment sale. Two years later, Sue became a California resident. After she became a resident, she received installment proceeds. California taxes Sue's installment proceeds received from the date she became a resident because California residents are taxed on income from all sources.

### Sale prior to residency

A cash-basis taxpayer was subject to California tax on gain from the sale of a business located in Washington because the proceeds of the sale were received after she became a California resident. Although the sale occurred while she was a California nonresident, the payment was not received until after she became a resident and was not reported for federal purposes until after she became a resident. (***Appeal of Sara K. Crossett*** (May 25, 2011) Cal. St. Bd. of Equal., Case No. 516193)

# INSTALLMENT SALES — INTANGIBLE ASSETS

18 Cal. Code Regs. §17952 states that California will tax nonresidents on the installment gain from a sale of an intangible if the sale was made while the taxpayer was a California resident.

Any taxpayer who wants to move to a nontax state prior to selling a business or other asset not sourced to California must make the move and become a nonresident before the sale.

***Example of sale of an intangible***

In September of Year 1, while a California resident, I.M. Gone sold stock (intangible property) in an installment sale. On February 1 of Year 2, Gone became a Florida resident, and on May 1 of Year 2, Gone received installment proceeds consisting of a principal payment (including capital gain income) and interest income.

The capital gain income from the sale of the stock is taxable by California because Gone was a California resident when he sold the stock. The interest income is not taxable by California because he was a nonresident of California when he received the proceeds.

# SALES OF PRINCIPAL RESIDENCES

California conforms with exceptions to federal law relating to the $250,000 and $500,000 capital gains exclusions for sales of principal residences. (R&TC §17152)

A nonresident could still qualify for an IRC §121 exclusion if the taxpayer met the two-out-of-five year test.

***Example of nonresident selling California residence***

Jed purchased his principal residence in 1999 for $100,000. He moved to Arkansas in 2013. Because the housing market was poor, he rented his former residence from July 1, 2013, until August 10, 2015, when he sold it for $550,000. Jed may exclude $250,000 of gain for federal and California purposes. He must report the excess over the §121 amount, or $200,000 ($550,000 - $100,000 basis - $250,000 §121 exclusion) to California.

# PASSIVE ACTIVITIES

## Nonresidents

Nonresidents net California-source items only and carry over only California-source suspended losses.

> ***Example of suspended passive loss***
>
> Katie is a resident of Florida. She has a California passive loss of $5,000 and Florida passive income of $6,000. As a nonresident, she does not offset her California passive loss with her non-California passive income. She has a California-source suspended loss of $5,000 that she can use to offset future California-source passive income.
>
> Deanna is also a resident of Florida. She has California passive income of $5,000 and Florida passive loss of $6,000. As a nonresident, she may not offset the California income with the Florida loss and must report $5,000 taxable income to California.

## Former nonresidents

A former nonresident must recalculate suspended passive loss for California purposes as if she had been a California resident for all prior years.

> ***Example of former nonresident with suspended loss***
>
> Using the example above, Katie and Deanna become California residents on January 1 of the following year. They must recompute their suspended passive losses as if they had been California residents for all prior years. Katie will have no passive loss carryover. Deanna will have a $1,000 passive loss carryover.

## Former residents

A former resident will recalculate a carryover loss as if the former resident had been a nonresident in all prior years.

> ***Example of former resident***
>
> In Year 1, Brenda was a resident of California with a California-source prior-year suspended passive loss of $10,000 and Florida passive income of $8,000. If Brenda were a resident in Year 2, her suspended loss would be $2,000. However, Brenda becomes a nonresident of California on January 1 of Year 2. Her suspended loss is $10,000, computed as if she had been a nonresident for all prior years.

## Part-year residents

According to the FTB, taxpayers must calculate the carryover loss on the part-year resident return by prorating the prior-year suspended loss using any reasonable method. The FTB instructions suggest using a formula based on the number of days the taxpayer spent as a resident and the number of days as a nonresident. If the taxpayer can justify another method, the FTB will consider it. One method to use would be the cut-off method, which looks at when during the year residency status changed and the amount of income before and after the change. The carryover to the following year is restated as if the taxpayer had been a resident (or nonresident) for all prior years.

*Example of proration method*

Cheri changed residence from California to Colorado on January 31 of Year 2. She has a California passive loss carryover of $5,000 and a Colorado passive loss carryover of $1,000 from Year 1. In Year 2, she has $2,000 income from her California rental property and $4,800 income from her Colorado rental property. Her federal AGI is $80,000, and she actively participates in the rental property.

For California purposes, her Year 2 income is:

| | |
|---|---|
| California property | $2,000 |
| Colorado property ($4,800 ÷ 12 months) | + 400 |
| Residence for one month | $2,400 |

**Part I**

**Step 1:** Period of residency.

| | |
|---|---|
| Year 1 carryover as if a California resident | ($6,000) |
| 31 resident days ÷ 365 days | × 0.0849 |
| | ($ 510) |

**Step 2:** Period of nonresidency.

| | |
|---|---|
| Year 1 carryover as if a California nonresident | ($5,000) |
| 334 nonresident days ÷ 365 days | × 0.9151 |
| | ($4,575) |

**Step 3:** Carryover to Year 2 allowed.

| | |
|---|---|
| Carryover from Step 1 | ( $510) |
| Carryover from Step 2 | + ( 4,575) |
| Total allowed to offset Year 2 income | ($5,085) |
| California-source income in Year 2 | 2,400 |
| Loss carryover from Step 3 | + ( 5,085) |
| | $2,685 |

**Part II: Carryover computed to Year 3**

| | |
|---|---|
| Year 1 carryover of California losses | ($5,000) |
| Year 2 California income | + 2,000 |
| Year 2 carryover to Year 3 | ($3,000) |

***Example of cut-off method***

Sally became a California nonresident on July 1 of Year 2. She had a $5,000 suspended passive loss from her Nevada rental on her Year 1 (prior-year) return. From January through June, the rental generated a net income of $4,000, and from July 1 through the end of the year the rental generated net income of $1,000. Sally's Year 2 AGI is $250,000. Assuming Sally can substantiate the timing of the income and deductions on the property, she may compute her Year 2 California-source income from the rental as follows:

| | Taxable to California | All-source under California law | Federal |
|---|---|---|---|
| Suspended loss | ($5,000)[1] | ($5,000) | ($5,000) |
| Net income taxable to California | 4,000 | | |
| Income from all sources | | 5,000 | |
| Taxable for federal purposes | | | 5,000 |
| | $ 0[2] | $ 0 | $ 0 |

[1] Loss is available to offset passive income because it was available on January 1 of Year 2
[2] Due to Sally's AGI, she may not deduct the net loss as a California-source loss

# NET OPERATING LOSSES

When computing a net operating loss (NOL), a nonresident must segregate California income and losses. The taxpayer may have a California-source NOL even if there is no NOL from income from all sources. Thus, it is important to file returns to compute the NOL for a nonresident who has California losses. (R&TC §17041(i))

***Example of nonresident with NOL***

In Year 1, Hap P. Trails is a Texas resident with a California rental property and Texas wages of $100,000. He has a California NOL of $11,000 that he can carry forward to offset California gains in the following year.

According to the FTB, a former nonresident must recompute the NOL using income and deductions from all sources to compute the California NOL.

***Example of new resident with NOL***

Assume that Hap becomes a California resident in Year 2. He must recompute his NOL as if he had been a California resident in all prior years. As a "resident" in Year 1, he would not have had an NOL because his wages were greater than his rental loss. Thus, he cannot offset his California income while a resident with the NOL incurred as a Texas resident.

## NOL carryback

For years beginning after January 1, 2019, California does not allow NOL carrybacks.

# NONRESIDENTS' GROSS INCOME

## PERSONAL SERVICES

In the case of nonresident taxpayers, gross income includes only the gross income from sources within California. (R&TC §17951) Since 2013, California uses the single sales factor.

Multistate businesses, including Schedule C businesses must use the single sales factor and market-based sourcing.

This means service businesses, including sole proprietors and partnerships, must compute income taxable to California based on where the client is located, not a formula that generally sourced the majority of the income to the state of residence. (18 Cal. Code Regs. §25136-2 (operative January 1, 2011))

For more than 40 years, California generally looked to where the cost of performance was incurred to assign sales other than sales of tangible personal property for purposes of the sales factor. However, under 18 Cal. Code Regs. §25136-2, sales are assigned to the state in which the benefit occurs.

For taxable years beginning on or after January 1, 2013, the computation under 18 Cal. Code Regs. §17951-4(g) is no longer applicable. See page 74 for information on sourcing for nonresident withholding purposes.

***Example of allocation of accounting fees***

Jeff performs tax and accounting services both in California and Nevada, but is located in Nevada. Jeff performs tax and accounting services for a California client. Those fees are allocable to California, even if Jeff performs all services for this client in Nevada. If however, the practitioner performs no services for a California client, his services are not taxable to California.

Prior to enactment of the single sales factor, Jeff computed California apportioned income based on a formula that sourced income based on payroll, property, and sales. This computation included a percentage of profits allocated to the state of residence. This no longer applies.

### OTA precedential decision

In 2019, the OTA issued a precedential decision in ***Appeal of Bindley***, requiring a nonresident sole proprietor to pay California income tax on $40,000 in receipts from his California customers even though all the work for these customers was performed in Arizona. (***Appeal of Bindley*** (May 30, 2019) 2019-OTA-179P) As with other business entities, the OTA ruled that physical presence in California is not required in order to establish taxable nexus.

***Comment***

The ***Bindley*** decision was issued less than one year after the OTA had issued a nonprecedential decision in a similar case (***Larsen***) and reached the opposite result. (***Appeal of Larsen*** (July 25, 2018) 2018-OTA-073)

## Conducting business in California

In ***Bindley***, the OTA concluded that the taxpayer performed services in California because he received income from California customers. Based on this reasoning, because he was performing services both inside and outside California, he was required to apportion his income between the two states using the market-based sourcing rules, which assigns the income to the state in which the benefit was received (in this case, California). (18 Cal. Code Regs. §17951-4(c))

It was just this type of circular reasoning that the OTA previously rejected in the ***Larsen*** case, holding that in order to subject a nonresident sole proprietor to California taxation, the FTB must show that at least some of the work was actually performed in California.

### Unitary business

Under 18 Cal. Code Regs. §17951-4(c), a nonresident sole proprietor's income is only subject to apportionment, including the market-based sourcing rules, if his or her business is a unitary business carried on within and without California. Unfortunately, the regulation does not define "carried on" or "unitary."

However, the OTA stated that the definition of "unitary" can be inferred from 18 Cal. Code Regs. §17951-4(b), which states that a business is not unitary if the part conducted within the state is so separate and distinct from and unconnected to the part without the state such that the respective business activities are not part of a unitary business (e.g., a sole proprietor that has a California hotel and a manufacturing business conducted outside California, in which the owner was not involved in the management of the hotel).

According to the OTA, the taxpayer "rendered" his screenwriting services to California LLCs, and this constituted conducting business in California, and it was a "unitary business" because he controlled and managed this "one-service" business, which was an "interrelated and interdependent business employing and consuming the same resources." Therefore, he was conducting a unitary business carried on both inside and outside California and was subject to the market-based sourcing apportionment rules.

> ***Comment***
>
> It's hard to argue against a conclusion that a single business is "unitary" with itself. However, the unitary concept has historically applied to two different businesses (e.g., a wholesaler and a retailer, or a construction and a design service, or two unrelated types of businesses that have centralized management and operations).

### Market-based sourcing

The OTA upheld the FTB's findings that the income received from the California LLCs should be sourced to California. Under the market-based sourcing rules applied to sales of services, the income is sourced to where the benefit is received. (R&TC §25136)

Because both LLCs were registered and located in California, it was both "reasonable and rational for FTB to conclude that both LLCs received the benefit of the services within California."

### Records

Citing ***Bindley***, the OTA once again ruled that a nonresident sole proprietor with a California customer was required to source that income to California even though the work was performed outside California. In ***Appeal of Moro***, a Texas resident sole proprietor who performed services for a California pharmaceutical company was liable for tax on all nonemployee compensation paid to the

taxpayer and reported on the 1099-MISC filed by the pharmaceutical company, even though the vast majority of the work was performed by the taxpayer in Texas. (***Appeal of Moro***, 2019-OTA-381)

Because the taxpayer in ***Moro*** failed to provide a contract or books or records showing that the pharmaceutical company received the benefit of the services outside California, under California's cascading sourcing rules, it was reasonable for the FTB to presume the benefit was received in California because that was where the pharmaceutical company was located. (18 Cal. Code Regs. §25136-2(c))

### Cascading market-based sourcing rules

Under California's cascading market-based sourcing rules for services sold to business customers, receipts will be sourced to California if:

- The contract or the taxpayer's books and records show that the benefit was received in California;
- The contract/books and records do not show where the benefit was received, if it can be "reasonably approximated" that the benefit was received in California;
- The location where the benefit was received cannot be determined above, if the customer placed the order from California; and
- The location where the benefit was received cannot be determined above, if the customer's billing address is in California.

## Beware of 1099s

This means that going forward the FTB will be monitoring 1099s-NEC forms to determine if out-of-state sole proprietors have received income from California customers. If the nonresident's total income from all sources exceeds the nonresident filing thresholds, they will be required to file a California return and pay California tax on the income received from California customers that is sourced to California under the market-based sourcing rules. This applies regardless of how little income they receive from their California customers.

Not only must the sole proprietor pay California tax on his or her California-sourced income, the sole proprietor must also use total worldwide taxable income to determine the tax rate that is applied. (R&TC §17041(b)(2))

***Example of nonresident sole proprietor filing requirements***

Sam is a former California tax professional who moved to Nevada. She retained five of her California clients whom she charged a total of $2,500 for preparing their returns. She also prepared returns for clients in Nevada and other states whom she charged $5,000. Her expenses for his Schedule C were $1,500 so her net Schedule C income was $6,000. She must apportion the income to California as follows:

$$\$6{,}000 \times \frac{\$2{,}500 \text{ California Income}}{\$7{,}500 \text{ total income}} = \$2{,}000$$

## Possible remedy

The rule for employees of corporations is different from the rules for individuals and partnerships. For the shareholder-employee the employer must provide a reasonable allocation of wages to California. In this case, the employee could use a "days spent in California" method to allocate the wages. The corporation must be qualified to do business in California, meaning the $800 minimum tax will apply. However, the tax on the allocated wages could be less than the tax on the apportioned income.

***Example of shareholder/employee***

Trudy is a shareholder/employee of her C corporation and is a Florida resident, but her clients are all California individuals or businesses. She performs 90% of her services in Florida and 10% in California.

The corporation is qualified to do business in California and apportions its income to California based on market-based sourcing rules. Because Trudy is a shareholder of her corporation, her wage income would be apportioned to California based on the time spent working in California versus time spent working everywhere, or 10%.

Her C corporation income would all be apportioned to California because all the services were for California clients. However, if she salaries herself, that salary is a deduction to the corporation, and she can plan her corporate income to be at or below the $800 minimum tax. Only 10% of her wages would be taxable to California. This might make the use of a corporation rather appealing, particularly if the taxpayer is in a nontax state.

# ALLOCATION OF INCOME FOR EMPLOYEES

Gross income from sources within and outside of California shall be allocated and apportioned under rules and regulations prescribed by the FTB. (R&TC §17954)

If nonresident employees are employed in California at intervals throughout the year, the gross income from sources within California includes that portion of the total compensation for personal services that the total number of working days employed within the state bears to the total number of working days both within and outside of the state. However, see page 46 for taxpayers in the transportation industry.

If the employees are paid on a mileage basis, the gross income from sources within California includes that portion of the total compensation for personal services which the number of miles traversed in California bears to the total number of miles traversed within and outside of the state. If the employees are paid on some other basis, the total compensation for personal services must be apportioned between California and other states and foreign countries in such a manner as to allocate to California that portion of the total compensation that is reasonably attributable to personal services performed in the state. (18 Cal. Code Regs. §17951-5)

## Salary allocation

Where a nonresident took very little vacation, income from sources within California was determined by apportioning to California that percentage of his salary that the total number of days spent in California bore to the total number of days in the year. (***Appeal of Louis and Betzi Akerstrom*** (May 17, 1960) 60-SBE-009)

## Telecommuting from/to another state

For income tax purposes, if a nonresident has come to California and performs the work in California, it is California-source income and taxable to California. (18 Cal. Code Regs. §17951-5) The "nonresident" employee is subject to California tax on all California-source income. However, the out-of-state employer will likely not be required to withhold California income tax if the employer is not doing business in California. This means that not only will the telecommuting employee have to pay tax on the California-source income, the employee's California tax liability come April 15 also will be much larger because no taxes were withheld.

***Example of nonresident employee working in California***

Harold is a marketing professional employed in New Jersey, but temporarily living and working out of his parents' California home so he is able to care for them. The New Jersey firm that he works for has continued to withhold New Jersey income taxes, rather than California taxes, from his paycheck. Harold has California-source income and should file a California return to report his California-source income.

As he will be taxable to New Jersey on the income because he is a resident of New Jersey, he will claim a credit for tax paid to California on his New Jersey resident return.

Conversely, if a California worker is telecommuting from another state and has not abandoned their California residency, California will continue to tax that income because California residents are taxed on their worldwide income. However, the taxpayer will likely be able to claim an Other State Tax Credit on the California return (or the nonresident return if the taxpayer is telecommuting from Arizona, Oregon, or Virginia). (R&TC §18001)

***Comment***

The big question is, if the employee doesn't use their temporary address on their tax return, how will the FTB or these other states know that the employee is working temporarily in their state if the employer is not withholding taxes?

## ENTERTAINERS AND ATHLETES

For independent contractor entertainers or athletes who earn prize money, gross income means the amount earned per performance or the prize money earned per event.

***Example of prize money***

Hula Hulk is a wrestler who is a resident of Nevada. During the year, she performed two matches in California and earned a total of $50,000 for those matches. Her California-source income is $50,000.

For entertainers and athletes who earn a salary or are paid on a project basis, the determination is more complex. The two issues that frequently arise in connection with state sourcing pertain to apportionable amounts and apportionment methods.

Generally, the amount is a simple matter: It's the total amount of salary or contract. However, the true amount of the salary becomes an issue when part of an athlete's compensation is in the form of a "signing bonus." In the most literal sense, a signing bonus is a payment for signing a contract and for the player's promise not to play for another team. As such, for tax purposes, it is characterized as a covenant not to compete and is allocated entirely to the athlete's state of residence. (18 Cal. Code Regs. §17951-6; ***Appeal of George and Sheila J. Foster*** (November 14, 1984) 84-SBE-159)

The method used to determine the amount of salary apportionable is the "duty days" ratio method (i.e., the ratio of the number of work days spent in California to the total number of work days in the year on salary or on a project contract). Duty days will include all activities pertaining to the position, including performances, practice sessions, meetings, and other work activity to which the entertainer or athlete is contractually bound. The duty days formula has been applied to both athletes and entertainers. (***Newman v. Franchise Tax Board*** (1989) 208 Cal.App.3d 972)

***Example of signing bonus***

Tiger Jordan is a resident of Ely, Nevada. He gets a $200 billion signing bonus and a $300 billion first-year salary to play basketball for the professional team in Sacramento. He must return $150 billion of the signing bonus if he fails any part of the performance contract in the first year, but he gets to keep $50 billion just for signing the contract. As such, $50 billion of the signing bonus is allocated to his state of residence. The balance of the signing bonus plus the first-year salary ($450 billion) is apportioned to the states where he works under the duty days method.

However, most signing bonuses are actually playing bonuses that must be treated as salary. The factor that most often differentiates a true signing bonus from a playing bonus is whether by the terms of the bonus it is refundable upon the player's failure to perform services for the team. (***Appeal of Garrison Hearst, et al.*** (November 13, 2002) 2002-SBE-007; ***Appeal of Desmond Howard*** (2003) Cal. St. Bd. of Equal., Case No. 17322) In one case, the Board bifurcated the initial bonus into a signing bonus and a playing bonus. (***Appeal of Testaverde*** (February 1, 2000) 2000-SBE-197)

The amount of a nonresident athlete's income that is subject to California tax may be determined by using this formula:

$$\frac{\text{Days available for play in California}}{\text{Total days available for play}} \times \text{Salary}$$

**OR**

$$\frac{\text{Games played in California}}{\text{Total games played}} \times \text{Salary}$$

(***Appeal of Edward and Carol McAneeley*** (October 20, 1980) 80-SBE-131)

## Different formulas for different athletes

For sports such as football, baseball, and basketball, where the athlete is paid for a season or a period of games to be played in various states, the FTB allocates California income based on days available versus total days, multiplied by the athlete's salary.

For a golfer or other athlete who earns prize money for a particular game or event, the FTB taxes 100% of the prize if it is earned in California.

A football player must take into account official pre-season training and extra days spent out of state in relation to away games when apportioning income to California. (***Appeal of Desmond Howard*** (February 5, 2003) Cal. St. Bd. of Equal., Case No. 173221)

It is not discriminatory for the FTB to use a "working day" formula to apportion the salary of a nonresident football player where application of the "games played" formula, which is used to apportion the salaries of most other nonresident athletes, would fail to provide the reasonable allocation required by law. (***Appeal of Dennis F. and Nancy Partee*** (October 6, 1976) 76-SBE-098)

A football player's salary must be allocated to California based on actual days worked in California versus total actual days worked for the team. Days spent conditioning at the taxpayer's residence or simply being "available" for meetings and promotional activities are not included in the formula. (***Marc D. Wilson, et al. v. Franchise Tax Board*** (1993) 20 Cal.App.4th 1441) A California court of appeal ruled that the FTB formula was correct because the contract "does not require any participation in off-season activity."

## Sporting events and pay-per-view

The FTB has stated that under the market-based sourcing rules, the revenue a fighter receives from pay-per-view sales is sourced to the state where the viewer is located. That is because under market-based sourcing, the sales of intangibles are sourced to the state where the benefit is received, not where the sale occurred.

What it comes down to is that California will likely receive significantly more tax from pay-per-view revenues than from the fight itself, with a significant accounting burden.

### Fact pattern

John, a resident of Florida, is an MMA fighter. The promoter is a California corporation that contracted with John to participate in an event to be held at a 30,000-person capacity sports complex in California.

The event is to be televised to PPV subscribers located in 40 states. The contract states John will receive proceeds from the event equal to 15% of ticket sales and 5% of the proceeds from PPV subscriptions. The contract specifies John is to receive a 2% bonus based on the PPV subscriptions if he wins. The contact requires John to participate in planned promotional appearances at local TV and radio stations prior to the event, as shown in the following table.

| **Promotional Appearances by State** | | |
|---|---|---|
| **State** | **Appearances** | **Percentage of total** |
| California | 40 | 40% |
| New York | 20 | 20% |
| Texas | 20 | 20% |
| Nevada | 5 | 5% |
| Other | 15 | 15% |
| **Total** | **100** | **100%** |

The proceeds from the event and PPV are to be considered compensation to John for his promotional appearances, and John will not be separately compensated for these appearances. Based on ticket sales, the promoter is to pay John $120,000. Based on PPV subscriptions, John is to receive $2.25 million, plus a bonus of $900,000 for winning. There were one million total viewers and $45 million in proceeds. The breakdown of PPV subscriptions was as follows:

| **PPV Viewers** | |
|---|---|
| **State** | **Percentage of total viewers** |
| California | 35% |
| New York | 30% |
| Texas | 20% |
| Nevada | 10% |
| Other | 5% |

### What's taxable?

Assuming that John is engaged in a trade or business, we can also assume that it is carried on within and outside of California. John is fighting in California and, most likely, training in Florida. Therefore, no matter which business structure John uses (Schedule C, corporation, or LLC), his income will be from a unitary multistate business. (18 Cal. Code Regs. §17951-4) As such, we must look to R&TC §§25120–25139 and the regulations thereunder.

"Sales from services are in this state to the extent the purchaser of the service received the benefit of the services in this state." (R&TC §25136(a)(1)) There are specific rules concerning the amount of business income from sources within California with respect to income from "cable television services." (R&TC §25137; 18 Cal. Code Regs. §25137-8.2)

R&TC §25136 applies to the proceeds based on ticket sales. The purchaser of the services is the promoter who receives the benefit of the services measured by the ticket sales (gate receipts) in California — the site of the fight. Therefore, the full $120,000 that John receives as his portion from ticket sales is sourced to California.

The proceeds measured by the PPV subscriptions would be sourced pursuant to 18 Cal. Code. Regs. §25137-8.2(c)(3)(A)(iii), which provides that "Gross receipts, including advertising revenue, from films in release to subscription television telecasters shall be attributed to this state in the ratio that the subscribers for such telecaster located in California bears to the total subscribers of such telecaster everywhere."

Based on the facts provided, 35% of the viewers were located in California. Therefore 35% of John's income based on the PPV proceeds would be sourced to California. (In light of the single sales factor requirement, we need not consider payroll or property factors.)

Of the $3.15 million ($2.25 million base contract plus $900,000 for winning the fight) paid to John based on PPV proceeds, $1,102,500 would be sourced to California.

### Not a trade or business

If John is not engaged in a trade, business, or profession, 18 Cal. Code Regs. §17951-5(b) provides specific language for sourcing income for "nonresident actors, singers, performers, entertainers, wrestlers, boxers, etc.," to include income "received for performances in this State." So the entire income received from the promoter would be sourced to California.

Also, if John receives wage income from his business entity, the income will be sourced to California because employees are not considered to be engaged in a trade or business. Therefore, 18 Cal. Code Regs. §17951-5 would apply to source his wage income based on where he performed the services.

### Fight in Nevada

If John participates in another event, the sourcing would be done the same way.

Subsequent to the event at issue (but during the same taxable year), John contracted with the promoter to participate in another event held at a sports complex in Nevada. The terms of this contract were the same. John received $150,000 in proceeds from this event and $2.5 million in proceeds from PPV subscriptions, plus a bonus of $1 million for winning.

There were one million viewers and $50 million in proceeds. The breakdown of PPV subscriptions for this Nevada event was as follows:

| PPV Viewers | |
|---|---|
| **State** | **Percentage of total viewers** |
| California | 35% |
| New York | 30% |
| Texas | 20% |
| Nevada | 10% |
| Other | 5% |

John's income will be zero in ticket sales (not sourced to California-source income because the benefit of the service was received by the promoter in Nevada) and $1,225,000 PPV (35% × $3,500,000).

If John receives only wage income, that income would not be California-source income because he performed the services in Nevada. And if John is not engaged in a trade or business, none of the income from the Nevada event would be sourced to California for the same reason under Treas. Regs. §17951-5.

## Transportation employees

Under the federal shipping and transportation codes, the income of certain transportation employees is not taxable to states other than the employee's state of residence. California conforms to federal law that limits or prevents California from taxing the California-source income of certain nonresidents.

California cannot tax:

- A nonresident who performs regularly assigned duties while engaged as a master, officer, or crewman on a vessel operating in the navigable waters of two or more states. Only the state of residence may tax this income;
- A nonresident railroad employee who performs regularly assigned duties in two or more states. Only the state of residence may tax this income;
- A nonresident motor carrier employee who performs regularly assigned duties in two or more states. Only the state of residence may tax this income; and
- The income from military service performed in California received by a nonresident member of the armed forces stationed in California. Only the state of residence may tax this income. (R&TC §17951)

California can tax the California-source income of a nonresident airline employee if more than 50% of the pay received by the employee is earned in California.

## Other allocation cases

An Oregon resident who spent approximately one-half of each year in California was subject to tax on one-half of his annual salary, but his annual bonus was not subject to tax in California because operations in California showed a loss. (***Appeal of C. J. and Helen McKee*** (May 7, 1968) 68-SBE-023)

One-third of a nonresident corporate executive's salary was properly allocated to California where records indicated the executive spent one-third of the period in question in the state. (***Appeal of Oscar D. and Agatha E. Seltzer*** (November 18, 1980) 80-SBE-154)

See "California income: taxable or not taxable to a nonresident" on page 88.

# PENSION INCOME

## Pensions received after taxpayer becomes a resident

A pension accrued while the taxpayer was a nonresident, but was received after he became a resident and was taxable to California. (***Appeal of Joseph Daks*** (January 5, 1994) 94-SBE-001) The California Court of Appeal agreed with the Board. (***Joseph Daks v. Franchise Tax Board*** (June 24, 1999) 73 Cal.App.4th 31)

A taxpayer, a resident of Japan, retired on July 1, 1982, moved to California during July and received a lump-sum distribution in August. Although the right to receive the pension had accrued before the change of residence, California taxed it anyway. (***Appeal of Ralph G. McQuoid*** (May 11, 1989) 89-SBE-014)

## Pensions exempt by treaty

A pension received by a former member of the Netherlands military was exempt from federal taxes under a treaty between the two countries, but was taxable by California because the treaty did not mention California. (***Appeal of de Mey Van Streefkerk*** (November 6, 1985) 85-SBE-135)

## Pensions received by nonresidents

Under both federal and California law, qualified pension payments paid on or after January 1, 1996, to former California residents are not taxable by California. (4 USC §114; R&TC §17952.5) Thus, a California nonresident will not be taxed on pension payments received on or after this date. Qualified pensions include payments from:

- IRC §401(a) trusts exempt from taxation under IRC §501(a);
- IRC §401(k) plans (if they qualify under IRC §401(a));
- IRC §403(a) annuity plans;
- IRC §403(b) annuity contracts;
- IRC §408(k) SEP plans;
- IRC §414(d) government plans;
- IRC §457 deferred compensation plans;
- IRC §501(c)(18) trusts;
- IRC §7701(a)(37) individual retirement plans; and
- Retired partner payments.
  (H.R. 4019, P.L. 109-264; R&TC §17952.5)

The law also prohibits states from taxing nonresidents on payments received from certain nonqualified plans and deferred compensation plans if the payments are a part of a series of substantially equal periodic payments (made not less frequently than annually). The payments must be:

- Made for the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient);
- Made for a period of not less than 10 years; or
- Received after termination of employment under a plan, program, or arrangement maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by one or more sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415 of the IRC or any other limitation on contributions or benefits in such code on plans to which any of these sections apply.

A former resident's income from a NQSO did not fit the definition of either a "retirement plan" under 4 USC §114(b), or a "qualified retirement plan" under R&TC §17952.5(b) and was taxable to California. (***Appeal of Grubic*** (December 16, 2008) Cal. St. Bd. of Equal., Case No. 3804188)

### Life insurance retirement income

When a full-time insurance sales person retires, retirement income is often based on his or her book of business. Whether the income is taxable to California depends on:

- Whether the payments are nonqualified deferred compensation; and
- Whether the individual was considered a statutory employee.

For an individual who sold exclusively life insurance as a statutory employee, the pension is from a qualified plan. For agents who sold all types of insurance, including disability, auto, etc., and life insurance, the pension is paid on Form 1099 and is taxable to California for a nonresident. (FTB Legal Ruling 2011-02)

### Residents and part-year residents

California residents must still pay tax on all pensions received while they are California residents, even if the pension was earned out-of-state. If your client moves into or out of California during the year, you should report the pension payments received for the months in which the client was a resident of California. Only those payments received after the client becomes a nonresident are exempt from California taxation.

### Pension and IRA deduction for nonresidents

A nonresident with self-employment earned income from California sources may deduct a proportionate share of his Keogh, SEP, or SIMPLE deductions. The California-source deduction is computed by multiplying the federal deduction by a fraction, with earned income sourced in California as the numerator and total earned income used to support the contribution as the denominator.

> ***Example of reasonable allocation of Keogh deduction***
>
> Alice is a nonresident of California and a partner in a personal service partnership. Her share of the income from this partnership is $300,000. Her California-source income from this partnership is $100,000. She also has $25,000 of income received from a general partnership located in California in which she is a passive investor. Her federal Keogh deduction is $15,000 and her California deduction is $5,000 ($15,000 × ($100,000 ÷ $300,000)). (Legal Ruling 431 (November 2, 1988))

A taxpayer may deduct an IRA to the extent of California-sourced earned income.

## INTANGIBLE PROPERTY

Income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this state unless the property has acquired a business situs in this state. There is an exception: If a nonresident buys or sells such property in the state, or places orders with brokers in the state to buy or sell such property so regularly, systematically, and continuously as to constitute doing business in this state, the profit or gain derived from such activity is income from sources within this state irrespective of the situs of the property. (R&TC §17952)

## Business situs

Intangible personal property has a business situs in California if it is employed as capital in this state or the possession and control of the property has been localized in connection with a business, trade, or profession in California, so that its substantial use and value attach to and become an asset of the business, trade, or profession in California.

For example, if a nonresident pledges stocks, bonds, or other intangible personal property in California as security for the payment of indebtedness, taxes, etc., incurred in connection with a business in this state, the property has a business situs in California. Again, if a nonresident maintains a branch office in California and a bank account from which the agent in charge of the branch office may draw for the payment of expenses in connection with the activities of California, the bank account has a business situs in California.

If intangible personal property of a nonresident has acquired a business situs in California, the entire income from the property, including gains from the sale thereof, regardless of where the sale is consummated, is income from sources within California and is taxable to the nonresident. (18 Cal. Code Regs. §17952(c))

## Interest income

Taxpayers sold land in Hawaii on an installment sale and later became California residents. Because the situs of an intangible is the residence of the owner, the interest income was taxable by California. (***Appeal of Marvin and Alice Bainbridge*** (May 19, 1981) 81-SBE-043)

Ordinarily, interest and dividend income are not taxable to nonresidents, even though they are received from California banks and corporations. (R&TC §17952)

## Goodwill from personal services

The sale of goodwill in a tax and accounting practice would be allocable to California if the clients were California-based. It would seem that to the extent the clients were not residents of California, the nonresident tax professional would not allocate that portion of the sale to California.

***Example of sale of intangibles***

Matt is a resident of Nevada who performs services in California and Nevada. He sells his tax and accounting practice for $500,000 of goodwill. There is no covenant not to compete. The sales price is based on the prior year's gross income, of which $400,000 was from California clients and $100,000 was from clients outside of California. 80% ($400,000 ÷ $500,000) of the sales price is taxable to California.

## Nonresident investors

Dividends, interest, or gains and losses from "qualifying investment securities" are not taxable to a nonresident in any of the following situations:

- In the case of an individual, with respect to the qualifying investment securities, the taxpayer's only contact with California is through a broker, dealer, or investment advisor located in California;
- In the case of a partner's distributive share of income from qualifying investment securities, the partnership qualifies as an investment partnership, whether or not the partnership has a usual place of business in California;

- In the case of a beneficiary of a qualifying estate or trust, the taxpayer's only contact with this state is through an investment account managed by a corporate fiduciary located in California; or
- In the case of a unit holder in a regulated investment company (as defined in IRC §851), to the extent of the dividends distributed by the regulated investment company, whether or not the regulated investment company has a principal place of business in California.

***Comment***

The exclusion from income does not apply to income derived from investment activity that is interrelated with any trade or business activity of the nonresident or an entity in which the nonresident owns an interest in California, whose principal activities are separate and distinct from the acts of acquiring, managing, or disposing of qualified investment securities, or if those securities were acquired with working capital of a trade or business activity conducted in California in which the nonresident owns an interest.

See R&TC §§17955 and 23040.1 for definitions of investment partnerships, qualifying estate or trust, and qualifying investment securities.

## ALIMONY

Here is how alimony is taxed:

- Alimony received by a resident, whether paid by a nonresident or resident, is taxable;
- Alimony paid by a resident, even if paid to a nonresident, is deductible;
- Alimony received by a nonresident is not taxable by California; and
- Alimony paid during the period of residency is deductible.

Alimony paid during the period of nonresidency is allowed in the same ratio (not to exceed 1.00) that California AGI, computed without regard to the alimony deduction, bears to total AGI, computed without regard to the alimony deduction. (R&TC §17302)

Comment: California does not conform to the TCJA provision that does not include alimony deductions or income for decrees entered after December 31, 2018, so alimony is taxable and deductible for California purposes.

## REAL PROPERTY AND TANGIBLE PERSONAL PROPERTY

Income from real property and tangible personal property located in California is income from California sources. (18 Cal. Code Regs. §17951-3)

A new resident to California who sells property located outside of California that was acquired prior to the taxpayer becoming a California resident must reduce the basis of the property by the depreciation that would have been taken had the taxpayer been a California resident. (***Appeal of Charles E. Kuhn*** (November 21, 1991) 91-SBE-006)

A taxpayer may defer gain on the exchange of California property for non-California property. However, when a taxpayer who, under IRC §1031, deferred gain on California property to property located in another state sells the out-of-state property, according to the FTB the taxpayer must report to California any unrecognized gain on the California property previously sold. This applies to nonresidents and residents.

## Income from real property

Income that is derived from the ownership of California real property is sourced to California. (18 Cal. Code Regs. §17951-3) This means that California may tax that income regardless of the residency status of the taxpayer receiving the income.

The FTB has stated that, even when a mortgage is a recourse loan, any COD income from forgiveness of that loan would be derived from the ownership of the property and sourced to the state in which the property is located.

## Credit card debt

According to the FTB, credit card debt is sourced to the taxpayer's state of residence under the *mobilia* rule that "intangibles follow the person" ("*mobilia sequunter personam*" in Latin). (R&TC §17952)

***Example of credit card debt forgiven***

Erica is a California resident who moved to Nevada on March 15. Three months later, on June 15, her credit card company forgave $30,000 of the debt that she owed on her card.

Because Erica was a Nevada resident on the date the debt was forgiven, her COD income is sourced to Nevada.

***Example of COD and residency***

On June 1, Megan walked away from her principal residence, which had a mortgage of $500,000 and a FMV of $200,000. The $500,000 was all equity debt and was not excludable under the qualified principal residence rules.

The next day, June 2, Megan became a Nevada resident. On November 1 of the following year, the bank foreclosed on the home and issued a 1099-C of $300,000. Megan was not insolvent and the COD income was taxable.

Although she was a nonresident when the debt was cancelled, the $300,000 is taxable to California because the property was located in California.

***Example of COD and change of residency***

Frank was a Nevada resident who moved to California on January 15. Shortly thereafter, Frank sold his Nevada rental property in a short sale on November 1. The bank issued a 1099-C reporting the $125,000 of cancelled debt.

Because Frank was a California resident at the time the property was sold, the income is taxable to California if no other exclusions apply.

# MISCELLANEOUS

## Corporate liquidations

A taxpayer received a large gain from the liquidation of a corporation in which he was a shareholder. He contended that the gain was not taxable by California because the appreciation in value occurred prior to the time he became a California resident. The court of appeal held that the

entire gain was taxable in the year the corporation was liquidated because no income was realized until that year. (***Sweetland et al. v. Franchise Tax Board*** (1961) 192 Cal.App.2d 316)

### Contingent fees

The taxpayer, an attorney, received income under a contingent fee contract after he became a California resident. Because uncertainty regarding the amount to be received prevented accrual before the change of residence, it was taxable by California. (***Appeal of Louis E. and Elchite M. Dana*** (February 8, 1979) 79-SBE-036)

## BENEFICIARIES

Income of estates and trusts distributed or distributable to nonresident beneficiaries is income from sources within California only if distributed or distributable out of income of the estate or trust derived from sources within California. This means dividends, interest, capital gains on sale of securities, etc., distributed by a resident trust to a nonresident beneficiary would not ordinarily be taxable to the nonresident unless the securities that gave rise to the income were employed in connection with a trade or business in California. (R&TC §17953)

However, if a resident beneficiary receives a distribution from a nonresident trust, the distribution is fully taxable unless it has been previously taxed by California. But, if the beneficiary was a nonresident when the income accumulated, it may or may not be taxable by California, depending on whether or not it was accrued when the beneficiary changed residence. (R&TC §17554)

Income from real property or gain from the sale or transfer of real property has its source or situs where the realty is located. Therefore, a distribution from an estate to nonresident beneficiaries, which arose from the sale of real property located in California, was taxable by California. (***Appeal of Folke Jernberg et al.*** (November 19, 1986) 86-SBE-187)

## DEPRECIATION

The depreciation calculation for a new or former resident does not change. When calculating total income or California-source income, you must use California methods.

When a nonresident acquires depreciable property and places it in service in another state and depreciates it using a method and useful life not allowed by California, upon becoming a resident of California the taxpayer must adjust the basis for California tax purposes using a method and useful life allowed by California. (***Appeal of Charles E. Kuhn*** (November 21, 1991) 91-SBE-006; ***Appeal of Diane Reznik*** (February 3, 2009) Cal. St. Bd. of Equal., Case No. 397972)

A California resident was taxable on his share of the gain from the sale of an Oregon residence even though the amount resulted from a federal depreciation recapture. (***Appeal of Varma*** (March 22, 2011) Cal. St. Bd. of Equal., Case No. 464787)

# FILING THE RETURN

Part-year residents and nonresidents are required to file a Form 540NR if either of the following applies:

- The taxpayer(s) owes alternative minimum tax, kiddie tax, or any other taxes administered by the FTB; or
- The taxpayer (and spouse, if applicable) had either of the following equal to or greater than the filing requirements and filing status for the year in question:
    - California gross income, which is gross income from all sources computed under California law; or
    - California adjusted gross income, which is the taxpayer's federal AGI from all sources and California adjustments, computed under California law from all sources. (R&TC §18501)

With the exception for registered domestic partners, the filing status for California must be the same as the filing status used on the federal income tax return. However, separate returns may be filed for California if a joint federal return was filed and either of the following are true:

- One spouse was an active member of the military at any time during the year; or
- One spouse was a full-year nonresident and had no California-source income.

## The California method

In computing the California tax, the tax is computed as if the taxpayer had been a full-year resident and then multiplying that tax by a percentage the numerator of which is the California-source AGI divided by the AGI from all sources computed under California law.

$$\text{Tax liability as if the taxpayer were a full year resident} \times \frac{\text{AGI from California sources}}{\text{AGI from all sources computed under CA law}}$$

Nonresidents and part-year residents only pay tax on California-source income, but their worldwide income affects the rate at which their California-source income is taxed. This method of computing the tax rate is known as the "California method."

The California method of taxation does not tax out-of-state income that is received while a taxpayer is not a resident of California. Tax is calculated by multiplying the California-source taxable income of a nonresident or part-year resident by a rate equal to the tax computed on worldwide income as if the person were a resident. (R&TC §17041(b)(2))

Although this method has been challenged by numerous taxpayers as unconstitutional, the formula simply takes the out-of-state income into consideration in determining the tax rate that should apply to California income. (See, for example, ***Appeal of Hughes*** (August 23, 2011) Cal. St. Bd. of Equal., Case No. 507337) This method is not prohibited by the Privileges and Immunities Clause of the U.S. Constitution.

California law requires the calculation of three ratios to be applied to determine the prorated amounts of:

- **Itemized deductions or standard deductions:** This is calculated by dividing California AGI by total AGI, which results in a rate that is then applied to the itemized deductions or standard deductions to find the appropriate prorated amounts (R&TC §17304);
- **Income tax on California taxable income:** This is calculated by computing the tax on the total taxable income as if the taxpayer was a California resident, and then dividing that

amount by the total taxable income, which results in the rate to be applied to the California taxable income to determine the California tax (R&TC §17041(b)(2)); and

- **Allowable credits:** This is calculated by dividing the California taxable income by the total taxable income, which results in a rate that is then applied to the total exemption amount to find the prorated credits. (R&TC §17055)

### Cases on point

In these cases, taxpayers did not factor out-of-state income when calculating the rate of California tax, and all taxpayers lost upon appeal:

- A taxpayer who resided in California for part of the year and Connecticut for the rest of the year argued that the taxable income was correct but the amount of tax due was not mathematically correct using the tax tables. (***Appeal of Wilson*** (April 25, 2017; released December 11, 2017) Cal. St. Bd. of Equal., Case No. 920480)
- A taxpayer argued against the FTB's use of his Arizona wages to arrive at his rate of tax for his California income. (***Appeal of Zichichi*** (April 25, 2017; released December 11, 2017) Cal. St. Bd. of Equal., Case No. 910369) (On an unrelated note, the taxpayer in this appeal was also upset by the fact that the FTB called him on Valentine's Day to decline his offer in compromise.)
- A taxpayer incorrectly subtracted Oklahoma-source income from his Schedule CA. (***Appeal of Dianatkhah*** (September 23, 2014) Cal. St. Bd. of Equal., Case No. 732681) The taxpayer argued that he had included in income a prorated amount of the interest and dividend income earned while living in Oklahoma.
- Taxpayers did not factor in the wife's Nevada income earned while she was still living in Nevada, but her husband had already moved to California. (***Appeal of Diaz*** (September 23, 2014) Cal. St. Bd. of Equal., Case No. 739067) The taxpayers argued that whatever income the wife earned prior to moving back to California was not taxable.

# CREDITS

## OTHER STATE TAX CREDIT

Income from another state is often taxed to California as well as the other state. In an attempt to give the taxpayer some recourse when double taxation occurs, California allows an Other State Tax Credit (OSTC). (R&TC §§18001–18011)

California allows individuals, estates, or trusts to claim a credit for net income taxes imposed and paid to another state only on income that has a source within the other state and is taxed by California and the other state.

Generally, you take the credit for double-taxed income on the taxpayer's resident return. However, there are a few exceptions. For certain states, the credit is taken on the nonresident return. If you have income taxed by California and another state, use the chart below to determine where to take the credit.

| Other State Tax Credit — Where to Take It | | |
|---|---|---|
| **Taxpayer is:** | **Income is from:** | **Credit is taken on:** |
| California resident | Arizona, Guam, Oregon (see the following discussion for an exception), Virginia | Other state nonresident return |
| | Any state or U.S. possession not listed above | California resident tax return |
| California nonresident | Arizona, Guam, Indiana, Oregon, Virginia | California nonresident tax return |
| | Any state or U.S. possession not listed above | Other state resident return |
| **Note:** Indiana was a reverse credit state for years prior to 2017.<br>Source: R&TC §§18001, 18002, FTB Technical Advice Memorandum 2017-01; California Schedule S | | |

***Example of Other State Tax Credit taken by a California resident***

Franklin is a California resident and owns rental properties in California and Oregon. His California AGI was $60,000: $20,000 from rentals located in California and $40,000 from rentals located in Oregon. Oregon taxed him on $40,000; California taxed him on the entire $60,000. Assume he owes $200 tax to Oregon and $400 to California for the year. His Other State Tax Credit is calculated as follows:

Step 1: Income taxable by both states = $40,000 (Oregon rental income)
Step 2: $40,000 ÷ $60,000 (double-taxed income to total California adjusted gross income) = 67%
67% × $400 (tax paid to California) = $267
Step 3: $40,000 ÷ $40,000 (double-taxed income to the other state's adjusted gross income) = 100%
100% × $200 (tax paid to other state) = $200
Step 4: Other State Tax Credit = $200 (lesser of Steps 2 and 3)
Franklin will take this credit on the Oregon return.

## Oregon compensation exception

California residents are generally allowed a credit against California taxes for income taxes paid to Oregon on "qualifying compensation." (FTB Information Letter, dated July 29, 2010) Qualifying compensation includes wages paid by an employer to an employee for services performed in Oregon in connection with a qualifying film production. (Oregon Law Ch. 2005-559 §1)

California generally allows a credit to its residents for income taxes paid to another state and to California on the same income if the other state does not allow a credit to California residents on a particular type of income. (R&TC §18001)

Oregon does not allow California residents a credit against Oregon income taxes for taxes paid to California on qualifying compensation. Therefore, the FTB stated that they will generally allow a credit to California residents for income taxes paid to Oregon on qualifying compensation.

***Example of Oregon income***

Scott is a California resident and had qualifying compensation from acting in a film in Oregon in 2010. He will take a credit for tax paid to Oregon on his California resident return, not on his Oregon nonresident return.

Larry is a California resident and worked for two months in Oregon in a salmon fishery. He will receive a credit on his Oregon nonresident return for the tax paid to California and will not take a credit on the California return.

## How to calculate the credit

To claim the credit on the California return, complete Schedule S and attach it to Forms 540, 540NR, or 541.

You may not take the OSTC for any preference item or alternative or minimum tax paid to the other state. (R&TC §§18001, 18002) In addition, you may not use it to reduce the California tentative minimum tax or the alternative minimum tax for California.

The OSTC is not available to offset the 1% surtax for taxpayers with income in excess of $1 million.

## Tax paid on a composite/group return

If the tax was paid to certain states on a composite return, the credit goes on the California resident tax return, even though normally the credit would go on the nonresident return of the other state. (R&TC §18535) According to the Schedule S instructions, these are the states where the taxpayer's composite return income and withholding will go on the California resident return:

- Arizona;
- Guam;
- Indiana (for years prior to 2017);
- Oregon; and
- Virginia.

To claim the credit for one of these states on the California resident return, attach a statement to the return explaining that the income is part of a composite or group return, the amount of the income, the tax withheld, and the state involved.

To help in correct processing of the return:

- Attach a statement for each credit claimed explaining that this is part of a group return;
- Compute each credit separately on each amount of income. Don't lump all the income and credits into one line and say "See attached"; and
- If you have a credit from a composite/group return in than one state, figure the credit by completing a separate Schedule S for each state. Add the credits from each state's Schedule S, and enter the total on Form 540.

Even following these guidelines, the FTB may disallow the credit. We have suggested a box to check or a separate section to list the group return states. The FTB is looking into a resolution. In the meantime, the Tax Practitioner Hotline or a secure chat is your best bet if the credit is incorrectly disallowed.

A composite/group return is an election made with the entity. See page 73 for more information.

### No SSN or ITIN

For years beginning January 1, 2021, through December 31, 2025, foreign workers without a Social Security number or an ITIN may report and pay tax on income earned while working temporarily in California may be included in a nonresident group return. (AB 2660 (Ch. 20-102); §§18537, 18624)

### Tax paid through nonresident withholding

The rules for composite/group returns discussed above do not apply if there has been no election to be a member of the group but instead the investor is subject to nonresident withholding.

Unfortunately, for partners/members/S corporation shareholders who invest in out of state property or businesses, if the entity withholds tax because the taxpayer is a nonresident, the taxpayer must file a California return and show the withholding as a payment on the nonresident return.

***Example of out-of-state investments***

Will has two K-1s from non-California LLCs.

Group Return LLC has income from New York. Group withheld $500 from Will's $5,000 net income on a composite (or group) return. Will may not file a New York return and may claim the credit on the California return.

Nonresident LLC has $500 of income from Illinois and the LLC withheld $45 in tax based on Illinois' nonresident withholding rules. To claim a credit for the $45 in Illinois withholding, Will must file an Illinois return.

## Installment sales

Normally, California allows a credit only if the tax is paid to California and the other state in the same year. If your client is a nonresident at the time of a property sale, the gain from the sale is either sourced to the taxpayer's residence (for intangibles) or to the location of the property (for real property) at the time of the sale. However, if your client moves to California after the sale, and did not elect out of the installment method, they are faced with paying tax to the FTB on the receipts from the sale that are recognized during the period of residency. (18 Cal. Code Regs. §17952(d))

California law allows a taxpayer to make a different election than federal if the taxpayer is subject to California tax at the time of the sale. (R&TC §17024.5) If your client will sell property on a note before moving to California, you must plan ahead to avoid paying tax to the FTB. A good strategy is to report the sale of the property on the installment method for federal purposes, but elect out of the installment method on your client's California part-year resident return.

***Example of new resident taxed on installment sale***

Joan is a New Jersey resident who sells New Jersey property on the installment method in Year 1. She reports the gain on the installment method for federal purposes on her Year 1 return. Because she is not a California taxpayer and has no California-source income in year 1, she can't elect out of the installment sale method for California purposes. If Joan becomes a resident of California in Year 2, she must report installment gains to California beginning in Year 2 because she is a California resident.

***Example of new resident not taxed on installment sale***

If, however, Joan in the above example had a rental property in California in Year 1 and was required to file a California return, she would have been a California taxpayer and she could file California-only elections. In that case, she may elect out of the installment method in Year 1 for the sale of the New Jersey property on her Year 1 Form 540NR.

Now, because she elected out of the installment method for California purposes, when she moves to California in Year 2, she is not required to report any installment gains on her California return. If a taxpayer is stuck with a tax bill from California, as well as another state, look at California's OSTC for relief for any double-taxed income.

## Tax paid in different years

New York law requires that taxpayers who move out of state either pay the tax on the deferred gain on an installment note or post a bond and agree to continue to report to New York the annual installment note collections. If a taxpayer elects to report the gain and pay the tax on his or her final resident return, the California resident will receive a credit in the year the tax is paid to California.

Compute the other state tax for the current year using this formula:

$$\text{Other state tax paid in current year} = \frac{\text{Gain taxed to California in current year}}{\text{Total gain taxed to other state}} \times \text{Total tax paid to other state}$$

## Credit for tax paid to Maryland counties

Generally, the credit is not allowed for taxes paid to cities and counties. However, a portion of the taxes paid to Maryland counties is allowed in computing the credit for Maryland. The maximum amount includable in this credit is 20% of the state tax. (***Appeal of Daniel Q. and Janice R. Callister*** (February 25, 1999) 99-SBE-003)

## Additional time allowed to amend for tax paid to another state

A taxpayer who pays tax to another state has one year from the date the tax is paid to the other state to claim an OSTC with the FTB, notwithstanding any other statute of limitations. (R&TC §19311.5)

However, if the other state statute has expired and the taxpayer cannot amend that reverse credit state return to claim the credit for taxes paid to California, the tax still applies to California. (***Appeal of Jones***, 2020-OTA-013)

## Other State Tax Credit — a double-tax situation

Under California law, a taxpayer may take a credit for tax paid to another state if both California and the other state tax the same income. California only allows a credit if the income taxed by the other state would be taxed to a California nonresident. (R&TC §18001(c)) This means that a California resident who pays tax to another state may be required to pay tax to both California and the other state.

***Example of double tax***

Ben is a California resident who sold property in Hawaii in an installment sale. During the year, Ben received $10,000 in interest payments and $5,000 in taxable principal payments. Ben has no other interest in Hawaii property or business. Ben must file a Hawaii return and pay tax on $15,000 (both the principal and interest payments). Ben must report both the principal and interest payments to California because residents are taxable on income from all sources.

Ben will get a credit for the tax paid on the $5,000 principal payments, but he will not get a credit for the tax he pays Hawaii on the $10,000 interest payments because under California law, the interest payments are not sourced to Hawaii. (18 Cal. Code Regs. §17952)

## Revised Texas Franchise Tax and other state business taxes

The FTB released Legal Ruling 2017-01, explaining when individual taxpayers may claim the OSTC or a deduction for taxes paid to another state. We have been waiting for this guidance since the FTB promised it in February of 2016, after they began denying the OSTC for the Revised Texas Franchise Tax (RTFT). (FTB Technical Advice Memorandum 2016-01)

The ruling outlines the general rules for claiming the OSTC or deducting other-state taxes, and then goes through specific fact patterns addressing taxes paid to Arizona, and business taxes paid to Tennessee, Texas, Manhattan, Kentucky, and New York.

### Credit or deduction

The ruling states that the determination as to whether the payment of a tax to another state is eligible for the OSTC or is deductible for California purposes turns on:

- Whether the tax is properly characterized as a tax on, or according to, or measured by income; and if so
- Whether the tax is properly characterized as a net income tax.

If the tax is not properly characterized as a tax on, or according to, or measured by income, then the inquiry ends, and the taxpayer may claim a California deduction for the tax (assuming all other requirements are met), but the taxpayer may not claim the OSTC.

***Deducting taxes***

Individuals, partnerships, and corporations are not permitted to deduct gross or net income taxes paid to another state. (R&TC §§17201, 17220, 17853, 24345; ***Beamer v. Franchise Tax Bd.*** (1977) 19 Cal.3d 467) However, deductions are permitted for taxes not on, or according to, or measured by income or profits (a measure based on income, which includes gross and net income taxes) imposed by and paid to another state by an individual, partnership, or corporation in connection with "carrying on a trade or business" or "for production of income," with certain exceptions. (R&TC §§17201, 24345; ***Beamer***, supra)

If the tax is properly characterized as a net income tax, a further determination must be made as to whether the tax is imposed by and paid to the other state such that the taxpayer may claim the OSTC.

If the other state's tax is not a single, indivisible tax, but rather a multifaceted tax consisting of a conglomeration of "separate and independent taxes," each of the separate taxes is analyzed independently. Thus, it is possible for some portion of a multifaceted tax to be based on net income

and eligible for the OSTC and not deductible, while another portion is not based on income and is deductible but not eligible for the OSTC.

***Example of multifaceted tax***

State X imposes an excise tax on various businesses as follows:

- **Retail sales of tangible personal property:** 4% tax on the gross proceeds from the sales;
- **Manufacturing:** 2.5% tax on the gross proceeds derived from the sales; and
- **Service businesses and professionals:** 5% on net income.

Taxpayers may be subject to two or more rates depending on the taxpayer's activities.

Under the FTB's reasoning, this would be considered a multifaceted tax, and the service business would be eligible for the OSTC, but manufacturers and retailers would not be.

### The Revised Texas Franchise Tax

In the ruling, the FTB states that the RTFT does not qualify for the OSTC because it is not a tax on, or according to, or measured by income, regardless of the manner in which the entity's taxable margin is determined. The FTB states that the tax is a single, indivisible tax, because a taxpayer can only be subject to paying one tax on one base in any year, regardless of the number of activities in which the business engages. This is true even though the taxpayer may compute multiple margins in order to comply with the requirement that the lesser margin be utilized as the base upon which the tax is computed.

Although the tax does not qualify for the OSTC, it would be a deductible tax under this analysis.

For a more in-depth discussion of the analysis the FTB provides on determining the character of these taxes, as well as a discussion of the six specific fact patterns for taxes paid to other states, go to:

**Website**
www.caltax.com/files/2021/ostc.pdf

## Other situations discussed in Legal Ruling 2017-01

### Arizona partnership

The FTB determined that an Arizona resident, who is a 25% partner in a partnership that does business only in California, is entitled to the OSTC in determining her California income tax liability based on the tax she pays to Arizona on her *pro rata* share of the partnership's income.

### Tennessee S corporation

A California resident who is the sole shareholder of a Tennessee S corporation is entitled to the OSTC for only a portion of the tax paid to Tennessee by the S corporation. The ruling states that the OSTC is permitted for an excise tax paid to Tennessee, but not for the franchise tax paid to Tennessee.

### New York Metropolitan Commuter Transportation Mobility Tax

A taxpayer is not permitted to take the OSTC for the Metropolitan Commuter Transportation Mobility Tax (MCTMT) paid to New York.

### Kentucky Limited Liability Entity Tax

A California resident who is a member of an LLC that does business in Kentucky is not entitled to an OSTC for the amount of Limited Liability Entity Tax credit he used to satisfy his Kentucky income tax liability.

# MILITARY PERSONNEL

## NONRESIDENT CALIFORNIA MILITARY PERSONNEL

Military members who are domiciled outside California remain nonresidents, even though stationed in California, unless they establish a California domicile.

A nonresident military person on active duty in California does not become a resident by merely registering to vote in the state, buying a home, or claiming a homeowner's or veteran's property tax exemption. (Legal Ruling 54 (December 5, 1958); Legal Ruling 93 (December 5, 1958))

A nonresident military person becomes a resident for income tax purposes when he claims California residence to obtain a veteran's property tax exemption or a Cal-Vet loan. (Legal Ruling 309 (April 23, 1965))

R&TC §17140.5 is compatible with federal law and provides that:

- The military compensation of a servicemember not domiciled in California may not be used to increase the tax liability imposed on other income earned by that servicemember or that servicemember's spouse;
- The running of the statute of limitations for purposes of bringing an action in court or administrative proceeding (such as with the Office of Tax Appeals) is suspended for the period of a servicemember's military service;
- The rate of interest is limited to a maximum of 6% per year on any underpayment incurred before the servicemember enters military service;
- A servicemember not domiciled in California does not become a resident of California by reason of being present in this state solely in compliance with military orders;
- Military compensation of a servicemember not domiciled in California is not income for services performed or from sources within the state; and
- Native American servicemembers whose legal residence or domicile is a federal Indian reservation are treated as living on the federal Indian reservation and the compensation for military service is deemed to be income derived wholly from federal Indian reservation sources.

## SPOUSES OF NONRESIDENT MILITARY PERSONNEL

Spouses of nonresident military servicemembers stationed in California are not — in certain circumstances —subject to California tax on income they earn in California. As California nonresidents, qualified spouses may also exclude from California income their interest and dividends and other intangible income, which is taxed to the state of residence. This relief is part of the federal Military Spouses Residency Relief Act (MSRRA) (P.L. 111-97) that extends to military spouses several residency-related benefits afforded to servicemembers under the Servicemembers Civil Relief Act.

### MSRRA provisions

The MSRRA provides that a state may not tax the earned income of the nonresident spouse of a nonresident military member stationed in that state.

Here are the tax-related MSRRA provisions:

- A spouse is not deemed to have lost a residence or domicile in any state solely by reason of being absent to be with the servicemember serving in compliance with military orders; and
- A spouse is not deemed to have acquired a residence or domicile in any other state solely by reason of being there to be with the servicemember serving in compliance with military orders.

When preparing California returns for a nonresident military couple, the MSRRA only applies to a servicemember's spouse if:

- The servicemember and the spouse have the same residence or domicile outside of California; and
- The spouse is in California solely to be with the servicemember who is serving in compliance with military orders.

> ***Comment***
>
> The FTB may require spouses of servicemembers to provide proof that they meet the MSRRA criteria.

### Withholding on spouse's wages

Spouses whose wages are not subject to California income tax under the MSRRA may claim an exemption from California income tax withholding on Form DE 4, Employee's Withholding Allowance Certificate. A military-spouse employee who had state withholding taken out of his or her paychecks during the year must file Form 540NR, California Nonresident or Part-Year Resident Income Tax Return, with the FTB to get a refund.

The taxpayer and spouse are both nonresidents. When filing, do not include the military spouse's earned income in Columns D or E of Schedule CA (540NR).

### Military personnel nonmilitary wages

The MSRRA exemption from tax applies to the spouse, but does not apply to wages earned by the servicemember from a nonmilitary part-time or side job.

## COMPUTATION OF INCOME FOR NONRESIDENT MILITARY PERSONNEL

A tax jurisdiction may not use the "military compensation of a nonresident service member to increase the tax liability imposed on other income earned by the nonresident service member or spouse subject to tax by the jurisdiction." As a result, military compensation is excluded from AGI, taxable income, and AMT. Because California's computation of tax on California-source income of nonresident military members does not include the military income, the marginal rate on all income will be lower and the prorated tax will drop.

But it is not as simple as it sounds. Military compensation is included in federal AGI, which means that limitations based on federal AGI (such as medical expenses or miscellaneous itemized deductions, phaseout of itemized deductions, and exemption credits) are also affected.

Our research has shown that a military nonresident's tax may decrease by hundreds or even thousands of dollars in these situations:

- Married couples where the nonmilitary spouse works or has other income;
- Military taxpayers who have part-time nonmilitary jobs;
- Single or married taxpayers with nonmilitary income; and
- Married taxpayers who filed separately may save more tax by amending to file joint returns.

However, the military spouse's earned income is included in the income from all sources column, but not the income from California sources column.

***Example of nonresident military return***

Millie Terry was a nonresident servicemember stationed in California in 2019. In addition to her $50,000 military income, she had a part-time job and earned $15,000. Her husband Ben was employed in California and made $70,000. They also had $10,000 of net income from a California rental. They filed a joint return. Their itemized deductions included $2,000 of property taxes on their personal residence, $10,000 of mortgage interest, and $3,000 of miscellaneous itemized deductions.

| | Federal | Income from all sources under California law | California-source income |
|---|---|---|---|
| Wages (Ben) | $ 70,000 | $70,000 | |
| Wages (Millie nonmilitary) | 15,000 | 15,000 | 15,000 |
| Wages (Millie military) | 50,000 | | |
| California rental | 10,000 | 10,000 | 10,000 |
| AGI | $145,000 | $95,000 | $25,000 |
| Property tax | | $2,000 | |
| Mortgage interest | | 10,000 | |
| Miscellaneous | | 3,000 | |
| 2% reduction miscellaneous | | (1,900)[1] | |
| Standard/itemized deduction | $24,000 | $13,100 | $1,379[2] |
| **Taxable income** | | **$81,900** | **$23,621** |

[1] 2% of $95,000 (recomputed federal AGI)

[2] $13,100 × ($10,000 ÷ $95,000)

## CALIFORNIA MILITARY PERSONNEL ASSIGNED TO STATIONS OUTSIDE CALIFORNIA

California military personnel who leave California under permanent change of station orders become nonresidents of California for income tax purposes when they leave the state. All income received or earned prior to the date of departure is taxable by California. California military personnel who leave California under a temporary duty assignment remain California residents. (FTB Publication 1032, Tax Information for Military Personnel)

Unfortunately, the income computation does not apply to service personnel who have a California domicile but are stationed outside California. These individuals are taxed as nonresidents, but may not exclude military income from federal AGI if they have other California-source income.

The military pay of a taxpayer who is domiciled in California but stationed outside of California is taken into account when calculating the tax rate applied to his California-source income. (***Appeal of Stephen Haussmann*** (May 25, 2004) Cal. St. Bd. of Equal., Case No. 202272)

Nonresidents are taxable only on income from a California source, such as rents, royalties, sales of property, and businesses conducted in this state. Income from intangibles, such as dividends, interest, and sales of stock, is not taxable.

If the spouse of the service person remains in California, the spouse is taxable on all of his or her separate income, regardless of where it is earned. If the service person retains California domicile, the spouse is also taxable on his or her one-half community-property share of the military person's taxable military pay. (***Appeal of Naylor*** (December 11, 1963) 63-SBE-143)

### Combat zone was not residence

A taxpayer was denied a refund of California tax for one year that she claimed she was a nonresident because she was working overseas in a combat zone. (***Appeal of Batta*** (November 19, 2014) Cal. St. Bd. of Equal., Case No. 766498) She failed the 546-day residency exception under R&TC §17014(d), and the Board also noted that it was unlikely that she intended to make a combat zone her domicile or residence. Also, she still owned her home in California, operated a business from California, and did not establish any connections in the combat zone, such as obtaining a driver's license or renting a home. Therefore, her absence from California was temporary. Unfortunately, since she was not a member of the military, the exemption allowed for California military members stationed out of the country did not apply.

### Retirees

The Board held that California does not recognize "home of record" for retired military members, but determines residency based on factors such as a family home, bank accounts, business interests, voting registration, driver's license, and ownership of real property. (***Appeal of Tyrone Stallworth*** (March 7, 2001) Cal. St. Bd. of Equal., Case No. 78070)

See "Income reporting requirements for military servicemembers" on page 89 and "Cases" on page 90.

## NONRESIDENT ALIENS

A nonresident alien must file a joint return with his or her nonresident spouse if a joint federal return is filed. If a separate federal return is filed, a separate California return must be filed. A nonresident alien may claim credit for a dependent who is a United States citizen or a permanent resident of the United States, District of Columbia, Puerto Rico, any United States possession, Canada, or Mexico.

A taxpayer who was a nonresident alien for federal income tax purposes was a resident for California tax purposes and was subject to state income tax on the sale of his financial holdings in Mexico. Although he was domiciled in and a resident of Egypt, his presence in California was for other than a temporary or transitory purpose. (***Appeal of Riad Ghali*** (December 13, 1971) 71-SBE-037)

On the federal tax return, nonresident aliens with California-source income and foreign persons moving to California from a foreign country are not allowed the standard deduction and must itemize their deductions. (IRC §63(c)(6)) Although the California R&TC is confusing on this issue, according to the FTB, California allows the standard deduction.

# PASSTHROUGH ENTITIES

## PARTNERS AND PARTNERSHIPS

A nonresident partner's gross income includes only the gross income from sources within California. Income of nonresident partners from stocks, bonds, or other intangible personal property is not income from sources within the state unless:

- The property has acquired a business situs in California;
- The nonresident partnership buys or sells such property in the state; or
- The nonresident partnership places orders with California brokers to buy or sell such property so regularly, systematically, and continuously as to constitute doing business in the state.

Income from estates or trusts distributed to nonresident partnerships is deemed income from sources within the state only if the distributed income was derived from sources within the state. Gross income from sources within California is allocated and apportioned under rules prescribed by the FTB.

### Single sales factor

For years beginning on or after January 1, 2013, businesses must use a single sales factor to determine whether income is taxable to California. When a partnership has income from both inside and outside California, and the portion carried on in California is an integral part of a multistate partnership, the nonresident partner's income is determined by comparing sales allocated to California versus total sales. The four-factor formula — the ratio of California payroll, property, and sales (times two) to worldwide payroll, property, and sales — and 18 Cal. Code Regs. §17951-4(c) no longer applies.

Market-based sourcing applies to allocation of sales to California (see page 39).

California residents who are members of a partnership located outside California are taxable on the partnership income because a California resident is taxable on all income regardless of source.

## CALIFORNIA'S PASSTHROUGH ENTITY TAX

In 2021, California passed AB 150 (Ch. 21-82), which allows, for the 2021 through 2025 taxable years, a qualified S corporation, partnership, or LLC taxed as a partnership or S corporation to make an election to pay a passthrough entity elective tax equal to 9.3% of its qualified net income. This tax will decrease the federal net income included on the owners' K-1. (R&TC §§17052.10, 19900 et seq.)

California also allows the entity's consenting individual, estate, trust, and now certain single member LLC (SMLLC) owners to claim a credit on their California return of up to 100% of the tax paid on their behalf. (R&TC §17052.10)

***Comment***

This section addresses only the issues concerning these payments for nonresident owners. For a detailed discussion of this tax, and the related credit, see our on-demand webinar "California's Passthrough Entity Tax."

## How the passthrough entity elective tax/credit works

Qualified passthrough entities (described below) that make the election will pay the tax on behalf of consenting, qualified taxpayer owners (also discussed below).

The tax is deductible on the federal return but not the state return. In essence, this allows the K-1 recipient to reduce federal AGI rather than having a state tax deduction on Schedule A, which would be subject to the $10,000 state and local tax (SALT) deduction limit. For federal purposes, the net income is reduced by the amount of the tax paid at the entity level.

For California, the state tax deducted on the federal return is added back into net income on the California K-1, but the consenting owners will receive a California tax credit of up to 100% of the state tax paid by the passthrough entity on behalf of its owners.

***Example of making election***

Making Money, Inc, a California S corporation, has qualified net income of $400,000. Two shareholders each have a 50% interest. If both shareholders qualify and the election is made, the S corporation makes a payment of $37,200 ($400,000 × 9.3%) to the FTB. The S corporation then deducts the $37,200 on the federal return, which reduces each shareholder's net K-1 income from $200,000 to $181,400 (($400,000 - $37,200) × 50%).

The California returns filed by each of the shareholders will report $200,000 of net income from Making Money because the passthrough entity tax is added back on the California return. However, each shareholder will receive a credit of $18,600 ($37,200 × 50%) to use against their individual California income tax.

***Comment***

Bottom line, this tax allows passthrough entity owners to "buy" a federal tax deduction that gets around the $10,000 SALT limitation. The price for this increased deduction is essentially the loss of the use of the money from the time the tax is paid by the entity until the owner claims the credit on their return.

## Sourcing of income

The entity will include in its qualified net income calculation all of the consenting resident owners' distributive or *pro rata* share of income. For nonresident owners, only their post-apportioned share of the entity's income is included in the entity's qualified net income.

***Example of sourcing qualified net income***

ABC, Inc. is an S corporation with $1.3 million in net taxable income, $800,000 in California-source income, and $500,000 in Georgia-source income. ABC has two 50% shareholders, Ralph and Alice. Ralph is a Georgia resident, and Alice is a California resident.

If both Ralph and Alice consent to have ABC pay the tax on their behalf, ABC's qualified net income for purposes of the passthrough entity tax would be calculated as follows:

| | |
|---|---|
| Ralph's share ($800,000 × 50%) | $ 400,000 |
| Alice's share ($1,300,000 × 50%) | 650,000 |
| Total | $1,050,000 |

## OSTC and Passthrough Entity Elective Tax Credit interplay for California residents

For taxpayers with income from both inside and outside California, the interplay between the OSTC and the Passthrough Entity Elective Tax Credit may impact whether a taxpayer chooses to have an entity pay the passthrough entity elective tax on their behalf.

The OSTC is designed to provide relief to taxpayers whose income is being taxed by two different states. However, the credit is only available if the same income is being taxed by both states. This can occur when a California resident has income sourced to, and taxed by, another state, such as when a California resident has income from a passthrough entity conducting business in another state.

While this is undoubtedly welcome relief for most taxpayers, we found that many taxpayers who claimed the Passthrough Entity Elective Tax Credit for 2021 saw a significant decrease in the amount of OSTC they could claim. Unfortunately, the FTB alleges that reordering of the credits in SB 113 doesn't fix the problem (see "Wasn't this fixed by SB 113?" below).

### What's the issue?

When calculating the OSTC on the Schedule S, Other State Tax Credit, taxpayers determine the ratio of their double-taxed income taxable to California to California AGI and multiply that amount by the taxpayer's California tax liability. (R&TC §18001; Instructions to Schedule S, Other State Tax Credit) This is compared with the ratio of double taxed income taxable to the other state to the other state's AGI, multiplied by the tax liability paid to the other state. The amount of the OSTC is the lesser of the two products.

The problem that arises when the Passthrough Entity Elective Tax Credit comes into play is that when a taxpayer computes the amount of their California tax liability, the current Schedule S instructions require taxpayers to reduce the amount of their California tax liability by the amount of the Passthrough Entity Elective Tax Credit. This reduction can significantly reduce, if not eliminate, their California tax liability. The result is a substantially reduced OSTC.

### Getting less than you paid for

This reduction in the OSTC came as a big surprise to many tax professionals and their clients. Remember that, unlike any other credits, a taxpayer essentially "buys" the Passthrough Entity Elective Tax Credit by having the entity pay the tax on their behalf and receiving a dollar-for-dollar credit for the amount of tax paid. This is the price that taxpayers pay to get around the $10,000 federal state and local tax (SALT) deduction limitation.

But if a taxpayer winds up losing out on the amount of the OSTC they would have claimed anyway, they are not really getting what they "paid for" in terms of the Passthrough Entity Elective Tax Credit.

***Example of reduced OSTC***

Jane is a California resident with $291,588 of federal adjusted gross income, over $88,000 of which is non–California-source income. Prior to the passage of the Passthrough Entity Elective Tax Credit, Jane would be eligible for an OSTC of $4,069.

If she were to have a California partnership pay the passthrough entity elective tax of $15,000 on her behalf, as a qualified taxpayer she is eligible to claim a Passthrough Entity Elective Tax Credit of $15,000.

Reducing the amount of California "net tax" by the $15,000 Passthrough Entity Elective Tax Credit when calculating the OSTC, as the FTB is requiring, results in her OSTC being reduced to less than $400, and while Jane will be able to claim the $15,000 Passthrough Entity Elective Tax Credit, her total credits are now only equal to $15,400. This means she has essentially lost out on $3,669 in OSTC that she had previously received ($4,069 - $400).

## Wasn't this fixed by SB 113?

That's what we thought, but unfortunately the FTB does not agree.

SB 113 did change the credit ordering rules beginning with the 2022 taxable year so that the Passthrough Entity Elective Tax Credit is claimed after the OSTC. (R&TC §17039) We believed that this meant that the California tax liability used on line 2 of Schedule S that is used to calculate the amount of the OSTC would no longer be reduced by the Passthrough Entity Elective Tax Credit.

However, according to the FTB, the only result from changing the credit ordering rule is that taxpayers may claim the full OSTC (which does not allow any credit carryover) first and then claim the Passthrough Entity Elective Tax Credit (which has a five-year carryover for unused credits). For the 2021 tax year, the Passthrough Entity Elective Tax Credit is claimed first. For many taxpayers, the Passthrough Entity Elective Tax Credit reduces the tax liability to zero, which means that they are unable to claim the OSTC at all.

While changing the credit ordering starting with the 2022 tax year may benefit some taxpayers, it does not fully address the calculation issue discussed above. If the OSTC is reduced to a minimal amount (or completely eliminated), allowing the taxpayer to claim the OSTC first provides little benefit.

## A fix for the fix?

The FTB has stated that they believe a statutory change to R&TC §18001 is required to change the OSTC calculation. This means the Legislature will have to "fix the fix." If this is an issue for any of your clients, we recommend that they contact their legislators.

In the meantime, you will have to run the numbers to see if it still makes "cents" to have a passthrough entity pay the elective tax on behalf of your clients if the taxpayer will be claiming the OSTC. We know another fix is being discussed in Sacramento, but this is a major consideration for your clients considering June 15 prepayments for 2022 credits.

If your clients do not make a June 15 payment, they will lose the ability to elect to pay the passthrough entity elective tax and take the credit for 2022. If they make the payment, and there is ultimately no fix, they are not forced to make the election to pay the tax on their 2022 return. However, they will have to wait until the 2022 return is filed to request a refund of those June 15 payments.

## Some good news

As discussed above, the OSTC is based on the lesser of the tax paid to California or the other state on the double-taxed income. While according to the FTB a taxpayer's California tax liability is reduced by the Passthrough Entity Elective Tax Credit when computing the California tax paid on the double taxed income, this same result does not occur when computing the other state's tax liability on the double-taxed income.

According to the FTB, when calculating the tax liability paid to another state, the passthrough entity elective tax paid by the entity to the other state should be included in the amount of the other state's tax liability. This is true even if the amount of tax paid by the individual to the other state is eliminated or drastically reduced because the other state allows the individual passthrough entity owner to claim a credit or deduction for the tax paid by the entity on their behalf.

Under R&TC §18006, a partnership or S corporation is treated as if they directly paid their *pro rata* or distributive share of net income tax to another state. So even if the individual taxpayer's tax liability is dramatically reduced or eliminated by a credit or deduction related to the other state's elective passthrough entity tax, the individual's tax liability is increased on line 7 of the Schedule S by the amount of the individual's share of the tax paid by the entity.

***Example of tax paid to another state***

Fran is a California resident with K-1 income from a partnership that is taxed to New York. Fran has $100,000 of income that is taxed to New York, and she elects to pay the passthrough entity elective tax, which is $6,850.

Fran's individual tax on the New York state return is approximately $5,890, and the New York passthrough entity tax credit will eliminate her New York tax liability.

Fran is treated as if she paid her passthrough entity elective tax directly to New York. So although she pays no tax with her individual New York tax return, line 7 of the California Schedule S will show $6,850.

***Comment***

We can only hope that a provision similar to R&TC §18006 is enacted to achieve the same result when computing a taxpayer's California tax liability for purposes of the OSTC.

## Nonresident withholding

The passthrough entity tax is in addition to any other tax or fee that the passthrough entity may be subject to, including nonresident withholding.

There is no provision that would reduce the nonresident withholding required for distributions to nonresident shareholders, partners, or members that consent to having the passthrough entity elective tax paid on their behalf. This means that if an entity elected to pay the passthrough entity elective tax and distributed all of its net income, the nonresident owner would essentially pay 16.3% in withholding (7% nonresident withholding + 9.3% passthrough entity elective tax) to California on that income.

The passthrough entity does not file the FTB Form 592-PTE, Pass-Through Entity Annual Withholding Return, to report the passthrough entity elective tax. The passthrough entity elective tax is not considered withholding.

### This will create an issue beginning in 2022

R&TC §17039(b) states that the nonresident withholding credit must be treated in the same manner as the OSTC for the purposes of credit ordering. Because SB 113 changed the order of the credits beginning in 2022, the Passthrough Entity Elective Tax Credit will now be applied after the OSTC and the nonresident withholding credit.

Because the FTB is not allowing a reduction of nonresident withholding for taxpayers who have consented to have passthrough entity elective tax paid on their behalf, the nonresident withholding will significantly reduce or eliminate the tax that the Passthrough Entity Elective Tax Credit would apply to. This is an unfortunate situation because the nonresident withholding is refundable, but the Passthrough Entity Elective Tax Credit is not, meaning these taxpayers could forever lose the benefit of the Passthrough Entity Elective Tax Credits they paid for.

**Practice Pointer**

See page 75 for a discussion of requesting nonresident withholding waivers. Keep in mind, payees must file Form 588 at least 21 business days prior to the expected payment so the FTB can issue a determination letter before the withholding is due. Taxpayers considering waivers should submit their requests as soon as possible.

## CANCELLATION OF DEBT AND PPP LOAN FORGIVENESS

A taxpayer with income from inside or outside California is required to apply any deduction reductions to preapportioned income and must reduce the deductions by all expenses paid with forgiven PPP debt, even if they were not California expenses. They would then apply their apportionment formula to the adjusted income amount. This should be reflected on the California K-1.

***Example of multistate taxpayer***

Multistate Corp. operates across the United States. They have preapportioned taxable income of $1 million, and 30% of their sales were in California. Multistate received a $400,000 PPP loan, which was fully forgiven. They do not meet the 25% drop in gross receipts test, and they estimate that only 10% of those funds were used for California expenses.

| | |
|---|---|
| Preapportioned taxable income | $1,000,000 |
| Add back expenses paid with forgiven PPP debt | + 400,000 |
| Adjusted preapportioned income | 1,400,000 |
| Multiply by percentage of sales in California | × 30% |
| California taxable income | $ 420,000 |

## SALE OF PARTNERSHIP INTEREST

While California-source partnership income is taxable to a nonresident, the sale of a partnership interest by a nonresident individual is the sale of an intangible, and therefore not subject to California tax even when the main asset of the partnership was real estate located in California. (***Appeal of Amyas and Evelyn P. Ames, et al.*** (June 17, 1987) 87-SBE-042)

# BUSINESS INCOME OF INDIVIDUAL NONRESIDENTS

Proposition 39, passed in November 2012, requires all businesses operating in multiple states to use the single sales factor. As with most propositions, proponents ignored the computation complexities this change brought.

Using the single sales factor requires service businesses, including sole proprietors and partnerships, to compute income taxable to California based on where the client is located, not a formula that generally sourced the majority of the income to the state of residence.

## UNITARY PRINCIPLE

Businesses that derive income from sources both inside and outside California must use the unitary principle to determine the portion of total income attributable to California. Most businesses must apportion income based on a single sales factor rather than the previous four-factor formula consisting of payroll, property, and sales.

Under the unitary method, all of the elements comprising a single trade or business are viewed as a whole, or a unit, thus the term unitary.

The unitary business principle applies not only to multistate entities, but also to nonresident individual partners, S corporation shareholders, LLC members, and sole proprietors. If there is any business relationship between the business activity conducted inside California and that conducted outside of California, the individual, partnership, LLC, or S corporation must apportion the gross income or loss from the entire business and treat it as a single business. In essence, you must make a unitary determination for these trades and businesses. Although 18 Cal. Code Regs. §17951-4 no longer applies, the unitary principles found therein still apply.

***Example of unitary business***

Joe is a nonresident and a sole proprietor with business income of $100,000. Joe owns a 15% interest in ABC Partnership, which is engaged in a unitary business with Joe's sole proprietorship. Jane, Joe's sister, owns a 10% interest in ABC Partnership. Joe's Schedule K-1 (565) from ABC Partnership shows $30,000 of business income. Jane's Schedule K-1 (565) from ABC Partnership shows $20,000 of business income.

According to the regulation, Joe is treated as constructively owning Jane's interest in ABC Partnership. Thus, Joe constructively owns a 25% interest (his 15% and Jane's 10%) in ABC Partnership. Consequently, Joe is subject to the unitary principle, and the apportionment rules apply. However, Joe combines and apportions only the sum of his $100,000 sole proprietorship income and his own Schedule K-1 (565) business income. He does not include Jane's $30,000.

Residents may also be affected when computing credit for taxes paid to another state.

***Example of unitary business***

Ollie, a Colorado resident, owns 95% of an LLC that owns and operates three shopping malls in three different states. The malls in Colorado and Idaho have a profit, but the mall in California has a loss. With this organizational form, Ollie must apportion the business income generated by all three malls to California even though his business activity in California generates a loss.

In the next year, Ollie organizes each mall into a separate LLC. The LLC in California owns and operates the shopping mall located there, and Ollie thinks that the loss activity is now separated from the profitable activities and that no income will be reportable to California. Note that the LLC must pay the $800 annual tax, plus the fee based on total income.

Ollie must combine and apportion the income and loss from the three LLCs just as he did when the activity was reported together in a single LLC.

***Example of credit for taxes paid to other states***

Assume Ollie in the above example is a California resident. Although he is required to report 100% of his share of the passthrough income from the LLCs on his California return, he is eligible for a credit for taxes paid to Colorado and Idaho, but only if California law sources the income to those states. If California requires a combination at the taxpayer level, coupled with apportionment of the net income derived from the three shopping malls, then the income apportioned to the other states will be less, and the credit for taxes paid to other states will be reduced accordingly. (18 Cal. Code Regs. §18001-2(c))

## MARKET-BASED SOURCING

All taxpayers with income inside the state and outside the state must use the market-based sourcing rules. "All taxpayers" includes sole proprietorships and partners and partnerships.

### How the regulation works

18 Cal. Code Regs. §25136-2 (operative January 1, 2011): This regulation provides guidance on when sales from intangibles and services are allocated to California where the single sales factor is applied. The general rule is that these sales are in California if the taxpayer's market for the sales is in California. More specifically, sales from services are assigned to California to the extent the taxpayer's customer (the purchaser of the service) receives the benefit of the service in California. See page 38 for computation of Schedule C service income and the ***Bindley*** case.

## 20% RULE

If a taxpayer has a 20%-or-greater capital interest and profits interest in a passthrough entity, then the passthrough business activity must be combined at the individual owner level if the activities are unitary. Ownership includes direct and indirect ownership. So, an individual owner's portion of the income (or loss) is combined. The apportionment factor is also computed on a combined basis using the taxpayer's proportionate share of the property, payroll, and sales of each of the unitary activities.

The regulation states that if ownership is less than 20%, a presumption exists that the unitary principle will not normally apply. However, if in the judgment of the FTB the unitary principles are necessary to properly reflect income, the FTB may conduct a comparable, uncontrolled price examination — similar to the rule for combining S corporations — and combine such activities.

# COMPOSITE/GROUP RETURNS

S corporations, partnerships, and LLCs may elect to file a group (composite) nonresident return. It is filed on behalf of the electing nonresident individuals for their convenience.

The benefit to filing a group return is saving the time and cost of filing a complete California nonresident tax return if the partner's/shareholder's/member's ("owner's") only income from California sources is the entity's income, particularly if the amount of income flowing from the entity is small.

Passthrough entities report passthrough income, and C corporations report director's compensation.

A group nonresident return may be filed by:

- A business entity, acting as the authorized agent for its electing nonresident individual owners, to report the distributive shares of income from the business entity derived from California sources or from doing business in California (R&TC §18535); and
- A corporation, acting as the authorized agent for its electing nonresident directors, to report the directors' wages, salaries, fees, or other compensation from that corporation for director services performed in California, including attendance of board of directors' meetings in California. (R&TC §18536)

The business entity/corporation files the return and pays the tax on behalf of the electing nonresident individuals. A group nonresident return is considered a group of individual returns that meets the California individual income tax return filing requirement. Thus, a qualified nonresident individual who elects to be included in the group nonresident return does not file a separate personal income tax return for the tax year.

Individuals whose California taxable income is in excess of $1 million may be included in the group nonresident return. (R&TC §18536)

## Who can be included in the group return?

To be included in a group nonresident return:

- The taxpayer must be an individual, including a grantor trust (not recognized as a separate taxable entity for income tax purposes);
- The income from the business entity must be the individual's only California-source income, unless the only other California-source income is reported by the individual in other qualified group nonresident returns; and
- The individual must have been a California nonresident for the entire taxable year.

## No backing out of group return

A taxpayer could not file a claim for refund to remove LLC members who resided in states in which they are required to pay tax on their California-source income. (***Appeal of NorCal Investors, LLC*** (February 18, 2004) Cal. St. Bd. of Equal., Case No. 207199) A Nevada LLC filed a group nonresident return in 1993, which included several members who were residents of Virginia and

Oregon, which have reciprocity agreements with California where their residents may receive a credit for income taxes paid to California on income that is also taxable in their residence state. Consequently, the Virginia and Oregon members paid tax on their California income from the LLC to their state of residency, and to California, through the group return.

### Deductions and credits

Individual deductions, including itemized deductions, NOLs, and the standard deduction, are not allowed on the group nonresident return. However, a deduction for deferred compensation under IRC §§401–424 is allowed to an electing nonresident individual who has no earned income from any other source.

All normal limitations on capital losses are applied to group returns. Each individual's California-source capital losses are deductible to the extent of California-source capital gains, plus $3,000. The business entity must keep track of the California-source capital loss carryovers for each electing nonresident individual.

The business entity must complete a single Form FTB 3801, Passive Activity Loss Limitations, tracking the passive losses for the electing nonresident individuals. Passive losses are allowed only to the extent of passive income. The business entity must keep track of each electing individual's allocable share of passive loss carryovers.

Individual credits, such as personal, dependent, blind, and senior exemptions, are not allowed. Only business credits attributable to the entity's activities, such as the Manufacturers' Investment Credit, are allowed.

## NONRESIDENT WITHHOLDING REQUIREMENTS

Businesses that make payments to nonresident individuals, nonresident estates and trusts, and business entities — including corporations, partnerships, and LLCs — that do not have a permanent place of business in California and are not registered through the Office of the California Secretary of State (SOS) must withhold if California-source income exceeds $1,500. (R&TC §§18662, 18666) Backup withholding is also required for certain payments where the recipient is unknown or unidentified, or fails or refuses to provide a valid taxpayer identification number. (R&TC §§18661, 18664)

Nonresident withholding applies to payments made to nonresident:

- Independent contractors who provide services in California;
- Retirees receiving nonqualified distributions of pensions received from California;
- Partners;
- LLCs (taxed as partnerships);
- Beneficiaries of estates and trusts;
- S corporations (including LLCs electing to be taxed as corporations and electing S corporation status): and
- Landlords when rent is collected by a property manager. (Withholding is based on rent minus property manager's fee.)

# RATE OF WITHHOLDING

Payors must withhold at a rate of 7% on gross payments of California-source income. There is an exception for rents paid to a property manager. (18 Cal. Code Regs. §18662-5) A property manager may subtract its fee from the gross rent collected.

## $1,500 threshold

If the payor expects that the total calendar year distributions will exceed $1,500, it must withhold on the entire California-source income that is distributed, not just the amounts exceeding the $1,500 threshold. If, however, it did not "reasonably expect" the distributions to exceed $1,500, then there is no requirement for the partnership to "catch up."

## Withholding waivers and reduced rates

Withholding is not required if the FTB issues a waiver from withholding. Withholding waivers are allowed if the vendor has a history of filing California returns and/or is currently making estimated tax payments to the FTB.

The FTB may grant reduced rates when the 7% rate results in significant overwithholding or a waiver from withholding for taxpayers who have historically filed returns.

The FTB emphasizes that withholding is only required for nonresidents who fail to file California income tax returns. Compliant taxpayers will be granted a waiver upon request and verification that they have filed the past two years' California returns and paid taxes owed.

A nonresident can request a withholding waiver or reduced withholding. The FTB has provided two forms for these requests:

- **For those who have filed and paid:** File FTB Form 588, Nonresident Withholding Waiver Request. On this form, the nonresident payee may get a waiver from withholding based generally on California tax filing history. Form 588 must be submitted at least 21 business days before payment is made. Depending on the nonresident payee's tax filing history, the FTB may grant waived withholding for up to two years or the taxpayer may be required to refile the next year if this is the first year the nonresident has California-source income.
- **For others:** File FTB Form 589, Nonresident Reduced Withholding Request. On this form, the nonresident payee itemizes expenses against the California source income. Form 589 must be submitted at least 21 business days before payment is made. Once it is accepted, the FTB provides the withholding agent a letter stating the reduced withholding amount. Generally, nonresident property owners must file this form yearly.

***Example of withholding waiver or reduced withholding***

Myrtle moved to Maryland. She converted her California residence to a rental and hired M&M Property Managers to maintain the property. The rent (net of the property manager's commission) is $20,000 per year.

Although Myrtle's net income from the property will only be $2,000 in 2013 and her California tax liability will be $150, M&M will withhold $1,400 ($20,000 × 7%) unless Myrtle files Form 588 (and it is accepted) or Form 589 each year.

## Foreign (non-U.S.) partners

The rules relating to foreign nonresident, non-U.S. partners are slightly different. California generally conforms to IRC §1446 (R&TC §18666), which requires partnerships to withhold on amounts subject to IRC §1446 withholding based on the California-source income (effectively connected to the California trade or business).

For U.S. residents, the difference from the above requirements is that this requirement is based on income, not the distributions of that income.

California conforms to Treas. Regs. §1.1446-6 procedures, which allow foreign partners to request reduced or no withholding of California tax on effectively connected taxable income from California sources allocable to a foreign partner (or LLC members). The foreign partner/member must certify to the partnership/LLC, and to the FTB, that no or reduced California tax will be due. If the FTB approves the request, it will notify the foreign partner/member and the partnership.

Request reduced withholding from the FTB annually before the first installment period using FTB Form 589, Nonresident Reduced Withholding Request. A foreign partner must submit a completed and signed IRS Form 8804-C, Certificate of Partner-Level Items to Reduce Section 1446 Withholding, with FTB Form 589. (FTB Tax News (June 1, 2011))

***Example of domestic and foreign nonresident partners***

ABC is a California partnership that operates a restaurant within California. Bernie and Lars are two partners in the company. Bernie is a domestic nonresident whose distributive share of the profit or loss is 20%. Lars is a foreign nonresident whose distributive share of the profit or loss is also 20%. ABC has ordinary income of $100,000 and distributes $5,000 to each partner on the last day of the taxable year. (Neither partner is granted a reduced or exemption from withholding.)

The calculations for the nonresident withholding are as follows:

| **Domestic nonresident withholding** | |
|---|---|
| Distributions | $5,000 |
| Withholding rate for domestic nonresident partners | × 7% |
| Bernie's domestic nonresident withholding | $ 350 |
| **Foreign nonresident withholding** | |
| Income | $100,000 |
| Partner's share of income | × 20% |
| California maximum tax rate | × 12.3% |
| Lars's foreign nonresident withholding | $ 2,460 |

# CHANGE OF RESIDENCE FOR K-1 RECIPIENTS

Partners, S corporation shareholders, and beneficiaries of certain trusts who change residency status during their own or the entity's year must prorate items of income, deduction, and credit between the periods of residency and nonresidency to determine the proper amount to be reported as income taxable by California. (Legal Ruling 2003-1 (April 7, 2003))

R&TC §17041(i) states that a part-year resident must report the sum of these two items:

- All items of income and deduction for the period of residency, regardless of source; and
- Gross income and deductions derived from sources within this state for the period of nonresidency.

In effect, a part-year resident must divide his or her taxable year into two distinct periods:

- For the period during which the part-year resident was a resident of California, all items of income and loss realized by the partnership during the partnership's taxable year are included in the partner's California taxable income; and
- For the period during which the part-year resident was a California nonresident, only gross income and deductions realized from sources within California are included in taxable income.

The same rules hold true for a shareholder of an S corporation and a beneficiary of a simple trust or a complex trust required to distribute income currently.

The FTB's position is consistent with federal law dealing with a taxpayer who has been both a resident alien and a nonresident alien in the same tax year or a U.S. citizen and non-U.S. citizen in the same tax year. (***Estate of Petschek v. Comm.*** (1983) 81 TC 260)

***Example of part-year resident partner***

Dot became a California resident on September 15. She has a 50% interest in ABC Partnership. ABC has a December 31 year-end and conducts business within and outside of California. For the current year ending December 31, Dot's K-1 from ABC shows that she has $10,000 of taxable income from all sources, $5,000 of which is sourced to California.

Dot was a resident for 108 days. In her California taxable income, she will include $6,480 of income from ABC, calculated under the FTB's legal ruling as follows:

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Portion of year Dot was a nonresident: | 257 | ÷ | 365 | × | $5,000 | = | $3,521 |
| Portion of year Dot was a resident: | 108 | ÷ | 365 | × | $10,000 | = | 2,959 |
| | | | | | | | $6,480 |

We think an easier way to look at it and arrive at the same conclusion is:

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| CA-source income regardless of residency: | | | 100% | × | $5,000 | = | $5,000 |
| Non-CA-source income: | 108 | ÷ | 365 | × | $5,000 | = | 1,480 |
| | | | | | | | $6,480 |

## PRORATE OR CUT-OFF METHOD

If the taxpayer has a breakdown of passthrough income from the periods of residency and nonresidency, the legal ruling directs the taxpayer to report actual amounts. However, if the taxpayer does not have the breakdown, the taxpayer must prorate the income based on the number of days as a California resident versus number of days as a nonresident during the entity's taxable year.

## FISCAL YEAR ENTITY

If the passthrough entity is a fiscal year entity, the ruling instructs the taxpayer to calculate the *pro rata* taxable amount based on days in the entity's fiscal year.

***Example of fiscal year prorate method***

Dash, a calendar-year individual resident of California, owns 50% of XYA, Inc., an S corporation. XYA has an October 31 year end and conducts business within and outside of California. For its October 31 year end, Dash's K-1 from XYA shows that Dash has $8,000 of taxable income from all sources, $3,000 of which is sourced to California. On June 10 of that year, Dash became a nonresident taxpayer.

Dash was a nonresident for 144 days of XYA's fiscal year (from June 10 through October 31) and a resident for 221 days (November 1 of the prior year through June 9 of the current year) of XYA's fiscal year. In California taxable income for the current year, Dash will include $6,028 of income from XYA, calculated as follows:

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| For the part of the year Dash was a nonresident: | 144 | ÷ | 365 | × | $3,000 | = | $1,184 |
| For the part of the year Dash was a resident: | 221 | ÷ | 365 | × | $8,000 | = | 4,844 |
| | | | | | | | $6,028 |

***Example of cut-off method***

Assume the same facts as the previous example, except that Dash obtains an interim statement from XYA that shows that for the period from November 1 of Year 1 through June 9 of Year 2, Dash had taxable income from all sources of $9,000, of which $2,000 is sourced to California. For the period June 10 of Year 2 through October 31 of Year 2, Dash has income from all sources of $2,000, of which $1,000 is sourced to California.

Dash will report $1,000 of California-source income during his period of nonresidency and $9,000 of all-source income during his period of residency.

# FILING STATUS AND FORM CHECKLIST

Use this checklist to determine which filing status and form to use for married taxpayers with California-source income.

| | Federal filing status | California filing status | File on Form |
|---|---|---|---|
| Both California residents | Joint | Joint | Resident return |
| | Separate | Separate | Resident return |
| One spouse CA resident, one spouse part-year resident or nonresident with CA-source income | Joint | Joint | 540NR, showing one spouse as a resident and one spouse as a nonresident or part-year resident |
| | Separate | Separate | Resident spouse uses resident return<br>Nonresident spouse uses 540NR |
| One spouse CA resident, other spouse nonresident with no CA-sources income | Joint | Joint | 540NR, showing one spouse as a resident and the other spouse as a nonresident |
| | Joint | Separate | Resident spouse uses resident return<br>Nonresident spouse uses 540NR |
| | Separate | Separate | Resident spouse uses resident return<br>Nonresident spouse uses 540NR |
| One spouse a part-year resident or nonresident other spouse a full-year nonresident with no CA-sources income | Joint | Joint | 540NR showing one spouse as a nonresident or part-year resident and other spouse as a nonresident |
| | Joint | Separate | Each files 540NR |
| | Separate | Separate | Each files 540NR |

# HOW TO SPLIT INCOME ON FORM 540NR

The following chart is a guide to split community income with your spouse based on domicile. Use the chart for married taxpayers who file Form 540NR, California Nonresident or Part-Year Resident Income Tax Return.

| | TAXPAYER'S DOMICILE | SPOUSE'S DOMICILE | Form 540NR, Married Filing Joint | Form 540NR, Married Filing Separate (taxpayer's) | Form 540NR, Married Filing Separate (spouse's) |
|---|---|---|---|---|---|
| **1** | Community Property State | Community Property State | Schedule CA (540NR), column A through column D: all income, all deductions | Schedule CA (540NR), column A through column D: half of all income, half of all deductions | Schedule CA (540NR), column A through column D: half of all income, half of all deductions |
| | | | Schedule CA (540NR) column E: all income taxable by California | Schedule CA (540NR) column E: half of all income taxable by California | Schedule CA (540NR) column E: half of all income taxable by California |
| | | | | | |
| **2** | Separate Property State | Separate Property State | Schedule CA (540NR), column A through column D: all income, all deductions | Schedule CA (540NR), column A through column D: all taxpayer's income, all taxpayer's deductions | Schedule CA (540NR), column A through column D: all spouse's income, all spouse's deductions |
| | | | Schedule CA (540NR) column E: all income taxable by California | Schedule CA (540NR) column E: all taxpayer's income taxable by California | Schedule CA (540NR) column E: all spouse's income taxable by California |
| | | | | | |
| **3** | Community Property State | Separate Property State | Schedule CA (540NR), column A through column D: all income, all deductions | Schedule CA (540NR), column A through column D: half of taxpayer's income, half of taxpayer's deductions | Schedule CA (540NR), column A through column D: all spouse's income plus half of taxpayer's income, all spouse's deductions plus half of taxpayer's deductions |
| | | | Schedule CA (540NR) column E: all income taxable by California | Schedule CA (540NR) column E: half of taxpayer's income taxable by California | Schedule CA (540NR) column E: all spouse's income taxable by California plus half of taxpayer's income taxable by California |
| | | | | | |
| **4** | Separate Property State | Community Property State | Schedule CA (540NR), column A through column D: all income, all deductions | Schedule CA (540NR), column A through column D: all taxpayer's income plus half of spouse's income, all taxpayer's deductions plus half of spouse's deductions | Schedule CA (540NR), column A through column D: half of spouse's income, half of spouse's deductions |
| | | | Schedule CA (540NR) column E: all income taxable by California | Schedule CA (540NR) column E: all taxpayer's income plus half of spouse's income taxable by California | Schedule CA (540NR) column E: half of spouse's income taxable by California |

# INCOME TAXABILITY CHART FOR RESIDENT TAXPAYER WITH NONRESIDENT SPOUSE

| | Taxable Percentage of Income when Nonresident Spouse is Domiciled in a: | |
|---|---|---|
| **Type of Income** | **Community Property State** | **Separate Property State** |
| Resident spouse's wages | 100 | 100 |
| Nonresident spouse's wages | 50 | 0 |
| California-source interest — joint account | 50 | 50 |
| Other state-source interest — joint account | 50 | 50 |
| Resident spouse's separate interest | 100 | 100 |
| Nonresident spouse's separate interest | 0 | 0 |
| California real property — jointly owned | 100 | 100 |
| Out-of-state real property — jointly owned | 50 | 50 |
| Resident spouse's real property — separately owned | 100 | 100 |
| Nonresident spouse's real property — separately owned | 0 | 0 |
| California-source partnership income — jointly owned | 100 | 100 |
| Out-of-state source partnership income — jointly owned | 50 | 50 |
| Resident spouse's partnership income — separately owned | 100 | 100 |
| Nonresident spouse's partnership income — separately owned | 0 | 0 |
| Sale of jointly owned stock | 50 | 50 |
| Resident spouse's sale of separately owned stock | 100 | 100 |
| Nonresident spouse's sale of separately owned stock | 0 | 0 |
| California stock sales and dividends — jointly owned | 50 | 50 |
| Out-of-state stock sales and dividends — jointly owned | 50 | 50 |

***Comment***

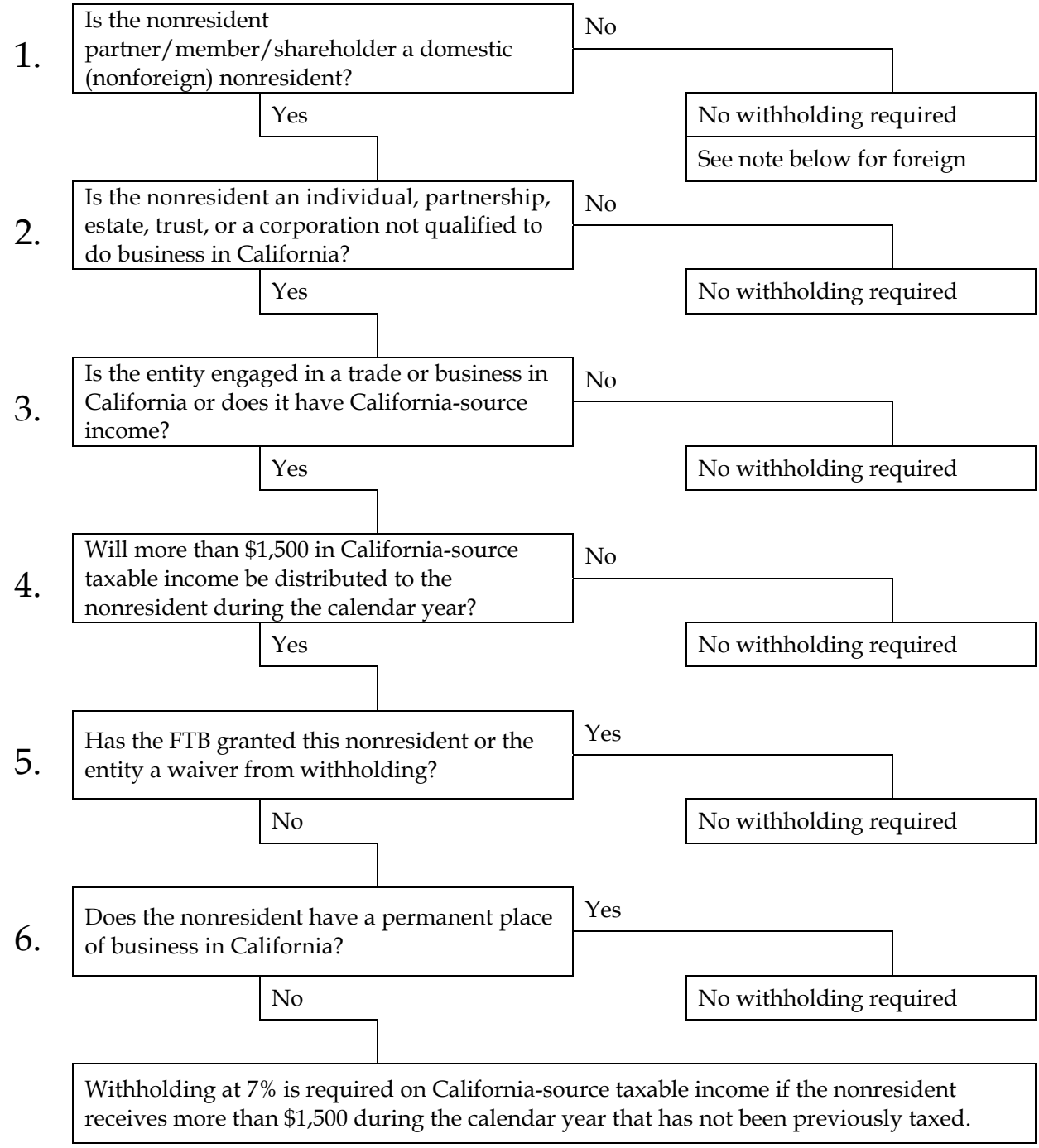
The taxability of pensions is somewhat more complicated and depends on when and where they were accrued, which spouse is receiving them, and whether that spouse is a resident or nonresident.

# NONRESIDENT WITHHOLDING CHART

| Nonresident Withholding Chart | | | |
|---|---|---|---|
| | **Domestic nonresidents (except partners, members, and shareholders)** | **Nonresident S corporation shareholders, domestic partners/members, and beneficiaries of estates and trusts** | **Foreign partners and members** |
| **Rate of withholding** | 7% | 7% | Noncorporate: 12.3%<br>Corporate: 8.84%<br>Foreign banks: 10.84% |
| **Withholding base** | California-source payments in excess of $1,500 in one year | Distributions of current or prior year income of more than $1,500 to any one shareholder, partner/member or beneficiary during the year | Distributions of effectively connected taxable income from California sources |
| **Date to remit withholding** | Quarterly:<br>April 15<br>June 15<br>September 15<br>January 15 | Quarterly:<br>April 15<br>June 15<br>September 15<br>January 15 | 15th day of the month following the 4th, 6th, 9th, and 12th months of the entity's tax year |
| **Form used to remit withholding** | 592-V, Payment Voucher for Resident and Nonresident Withholding | Form 592-Q, Payment Voucher for Pass-Through Entity Withholding | 592-A, Payment Voucher for Foreign Partner or Member Withholding |
| **Annual/quarterly report to the FTB** | 592, Quarterly Resident and Nonresident Withholding Statement | Form 592-PTE, Pass-Through Entity Annual Withholding Return, by January 31 of the year following year of withholding | 592-F, Foreign Partner or Member Annual Return, by 15th day of 3rd month following close of tax year |
| **Annual report to recipient** | 592-B, Resident and Nonresident Withholding Tax Statement, by January 31 (February 15 for brokers) following close of calendar year | 592-B, Resident and Nonresident Withholding Tax Statement, by January 31 (February 15 for brokers) following close of calendar year | 592-B, Resident and Nonresident Withholding Tax Statement, by 15th day of 3rd month following close of tax year (15th day of the 6th month if all partners are foreign) |
| **Exemption certificate** | 590, Withholding Exemption Certificate | 590, Withholding Exemption Certificate | N/A |
| **Waiver request** | 588, Nonresident Withholding Waiver Request | 588, Nonresident Withholding Waiver Request | N/A |
| **Reduced withholding request** | 589, Nonresident Reduced Withholding Request | 589, Nonresident Reduced Withholding Request | 589, Nonresident Reduced Withholding Request, with federal Form 8804-C, Certificate of Partner-Level Items to Reduce Section 1446 Withholding, attached |

# NONRESIDENT WITHHOLDING DECISION CHART

This chart applies to partners (partnership), members (LLC), and shareholders (S corporations).




**Note:** Foreign partner withholding is the maximum individual rate times the amount subject to withholding under IRC §1446 for corporations and for individuals, partnerships, LLCs, and fiduciaries. A reduced withholding may be requested in the case of effectively connected income. (Treas. Regs. §1.1446-6)

# STATE INCOME TAX WITHHOLDING WORKSHEET

*(For California nonresident (nonforeign) partners/members/shareholders/certain individuals)*

Entity name:

Entity ID number: _____

A. Nonresident (nonforeign) information

Name: SSN: _____

Year: _____ Month: _____

| | | (a) Current month | (b) Year to date |
|---|---|---|---|
| 1. | **Gross distributions from California-source income** | $ | $ |
| 2. | Less: Return of capital | ( ) | ( ) |
| 3. | Less: Previously taxed income | ( ) | ( ) |
| 4. | Less: Nontaxable distributions | ( ) | ( ) |
| 5. | **Net taxable distributions** | $ | $ |

6. If Item A.5.(b) is less than $1,500, stop and enter zero (0) in Items A.8.(a), A.8.(b), A.10.(a), and A.10.(b).

7. Subtract Item A.5.(a) from Item A.5(b). If the result is less than $1,500, enter the amount from Item A.5.(b) in Items A.8.(a) and A.8.(b). Otherwise, enter the amount from Item A.5.(a) in Item A.8.(a) and the amount from A.5.(b) in Item A.8.(b).

Item A.5(b) ..... $ _____
Less: Item A.5.(a)..... ( _____ )
_____

| | | | |
|---|---|---|---|
| 8. | **Distributions subject to withholding** | $ | $ |
| 9. | Times withholding percentage | × .07 | × .07 |
| 10. | **Amount withheld for this partner** | $ _____ | $ _____ |

B. Entity withholding information

**Total withholdings on distributions to nonresidents (nonforeign) subject to withholding**

| | | | |
|---|---|---|---|
| 1. | Amount from Item A.10.(b) for: | _____ (Nonresident name/Continuation sheet #) | $ |
| | | _____ (Nonresident name/Continuation sheet #) | _____ |
| 2. | Total amount withheld by entity (year to date) | | $ |
| 3. | Less: Amounts previously remitted to the FTB | | ( _____ ) |
| 4. | Amount of withholding still due to the FTB | | $ _____ |

Payments to the FTB must be remitted on FTB Form 592, which is due at the same time as estimated tax payments for calendar year taxpayers.

# CHECKLIST TO HELP DETERMINE CALIFORNIA RESIDENCY/NONRESIDENCY

Listed below are some questions that are commonly asked by the FTB to help determine whether a taxpayer is a resident or nonresident of California. These questions have various weights, depending on the facts and circumstances in the case.

To the best of our knowledge, only Question 1 positively determines nonresidency. (R&TC §17014) However, registering to vote in California and taking the homeowner's property tax exemption on a California residence have been found to make taxpayers residents of California regardless of any other factors (except for nonresident military personnel). (***Appeal of Pierre and Nicole Salinger*** (June 30, 1980) 80-SBE-089; ***Appeal of Frank J. Milos*** (February 24, 1984) 84-SBE-042) However, the converse is not true: Registering to vote in or taking the homeowner's property tax exemption on a residence in another state does not automatically make the taxpayer a nonresident as far as California is concerned. These factors include the commonly-cited factors in the ***Appeal of Stephen D. Bragg***, 2003-SBE-002)

As a general rule, the state or country in which the taxpayer (and spouse) has the closest business and social contacts is the state of residency.

Taxpayer's name _____ Year _____

T=Taxpayer S=Spouse

| | **Resident** | | **Nonresident** | |
|---|---|---|---|---|
| | **T** | **S** | **T** | **S** |
| 1. a. Are you employed under a contract that requires you to be absent from California for at least 546 days with not more than 45 days per year spent in California for any purpose? | ☐ No | ☐ No | ☐ Yes | ☐ Yes |
| b. If the answer to Question 1 is "Yes," did you have more than $200,000 in income from stocks, bonds, notes, or other intangible personal property in any taxable year in which the employment-related contract was in effect? If the answer to this question is yes, you do not qualify under this test. | ☐ Yes | ☐ Yes | ☐ No | ☐ No |

| | **California** | | **Elsewhere** | |
|---|---|---|---|---|
| | **T** | **S** | **T** | **S** |
| 2. During the year, how many months did you live | _____ | _____ | _____ | _____ |
| 3. How much of your income was from sources in: | _____ | _____ | _____ | _____ |
| 4. Where are you registered to vote? | _____ | _____ | _____ | _____ |
| 5. Do you own a house in: | _____ | _____ | _____ | _____ |
| 6. Where do you take your homeowner's exemption? | _____ | _____ | _____ | _____ |
| 7. Where is your driver's license issued? | _____ | _____ | _____ | _____ |
| 8. Where is your attorney located? | _____ | _____ | _____ | _____ |
| 9. Where is your stockbroker located? | _____ | _____ | _____ | _____ |
| 10. Where do you attend regular services? | _____ | _____ | _____ | _____ |
| 11. Where do you make regular religious contributions? | _____ | _____ | _____ | _____ |

| | California | | Elsewhere | |
|---|---|---|---|---|
| | **T** | **S** | **T** | **S** |
| 12. Where is your tax professional located? | _____ | _____ | _____ | _____ |
| 13. Where are your closest social contacts? | _____ | _____ | _____ | _____ |
| 14. Where are your closest business contacts? | _____ | _____ | _____ | _____ |
| 15. Where are your vehicles registered? | _____ | _____ | _____ | _____ |
| 16. Where do your children attend school? | _____ | _____ | _____ | _____ |
| 17. Did you pay nonresident tuition in: | _____ | _____ | _____ | _____ |
| 18. Where are your social clubs located? | _____ | _____ | _____ | _____ |
| 19. Where is your union or professional association located? | _____ | _____ | _____ | _____ |
| 20. Where is your bank located? | _____ | _____ | _____ | _____ |
| 21. If working outside California: | _____ | _____ | _____ | _____ |
| a. Where will you move to when your assignment is completed? | _____ | _____ | _____ | _____ |
| b. Where is your personal property stored? | _____ | _____ | _____ | _____ |
| c. Where do(es) your spouse (and minor children) live? | _____ | _____ | _____ | _____ |
| d. When you take vacation or time off, where do you visit? | _____ | _____ | _____ | _____ |
| e. Where is your permanent mailing address? | _____ | _____ | _____ | _____ |
| f. Do you own a house in: | _____ | _____ | _____ | _____ |
| i. Is it: | | | | |
| Rented | ☐ Yes ☐ No | ☐ Yes ☐ No | ☐ Yes ☐ No | ☐ Yes ☐ No |
| Leased | ☐ Yes ☐ No | ☐ Yes ☐ No | ☐ Yes ☐ No | ☐ Yes ☐ No |
| ii. Does a related party live there? | ☐ Yes ☐ No | ☐ Yes ☐ No | ☐ Yes ☐ No | ☐ Yes ☐ No |
| 22. If working in California or elsewhere on a temporary basis: | _____ | _____ | _____ | _____ |
| A. Where did you list your residence on the employment application? | ☐ Yes | ☐ Yes | ☐ No | ☐ No |
| B. Where is your permanent telephone number? | ☐ Yes | ☐ Yes | ☐ No | ☐ No |
| C. Do you cook your meals or eat out? | ☐ Cook | ☐ Cook | ☐ Eat Out | ☐ Eat Out |
| D. Did you deduct a moving expense? | ☐ Yes | ☐ Yes | ☐ No | ☐ No |
| E. Are you on an expense account or being paid per diem? | ☐ Yes | ☐ Yes | ☐ No | ☐ No |
| F. Are you: | ☐ Living in a hotel or motel | ☐ Renting month-to-month | | ☐ Leasing |
| G. Did you file a tax return in another state? | ☐ Yes | ☐ Yes | ☐ No | ☐ No |
| If so, did you file as a resident or | ☐ Nonres. | ☐ Nonres. | ☐ Resident | ☐ Resident |
| 23. Where did you have: | | | | |
| A. Your hair and nails done? | _____ | _____ | _____ | _____ |
| B. Your clothes cleaned? | _____ | _____ | _____ | _____ |
| C. Your pet(s) groomed? | _____ | _____ | _____ | _____ |

# CALIFORNIA NONRESIDENCY AND EMPLOYMENT CONTRACT PROVISIONS

"For taxable years beginning on or after January 1, 1994, any individual domiciled in this state who is absent from the state for an uninterrupted period of at least 546 consecutive days under an employment-related contract shall be considered outside this state for other than a temporary or transitory purpose." (R&TC §17014(d)) In order to meet the nonresidency rules of R&TC §17014(d), we suggest you include the following items in your employment contract.

| | |
|---|---|
| 1. | **Written contract.** R&TC §17014(d) merely states there is a required "employment-related contract." Without a written contract, the employee would not be able to prove the specific requirements required by the code. The FTB demands a written contract. |
| 2. | **Signed contract.** A contract is legally created when there are two parties to a transaction and there is (1) an offer, (2) acceptance, and (3) consideration. In order to avoid any question of these three requirements, the contract should be signed by the employer who is offering the employment, and the employee who is accepting the employment. The consideration from the employer is a salary and from the employee is the services to be provided out-of-state.<br><br>***Comment***<br><br>For a pre-existing employee, it is probably acceptable to have only a written order on company letterhead that states the employee is required to work outside of California — but why take a chance? |
| 3. | **Date of contract.** Sign and date the contract prior to the beginning of the "uninterrupted period of at least 546 consecutive days." Otherwise, the FTB could argue, and they are presumed correct, that it was not made for an uninterrupted period. This is especially true if the employee returns to California—whether for visits or for business purposes (as an employee). |
| 4. | **Employment-related provision.** Be sure the contract states that the individual is performing services as an employee or independent contractor. |
| 5. | **Uninterrupted period provision.** The contract must state that the employee will work for an uninterrupted period of at least 546 consecutive days. Although the employee may have vacations or come back to California for business purposes (as an employee), there must be no allowance for a break in the employment contract. (R&TC §17014(d)) |
| 6. | **45-day provision.** The individual may come back to California for vacation or for business reasons, but he or she may not be present in California more than 45 days during a taxable year. It may be advisable to state such a provision in the contract, but it is not a requirement. (R&TC §17014(d)(1)) |
| 7. | **Spousal provision.** A spouse who leaves for an uninterrupted period of at least 546 consecutive days may also be deemed a nonresident. It may be advisable to state such a provision in the contract, but it is not a requirement. (R&TC §17014(d)(3)) |

# CALIFORNIA INCOME: TAXABLE OR NOT TAXABLE TO A NONRESIDENT

| California Taxation of Nonresident Income | |
|---|---|
| **Type of Income** | **Taxability** |
| Income from business activities conducted solely in California | Taxable |
| Income from business activities conducted outside California by a California business | Apportionable[1] |
| Income from business activities conducted both in and outside California | Apportionable[1] |
| Real property located in California | Taxable |
| Real property located outside California | Not taxable |
| Income from tangible personal property located in California | Taxable |
| Income from tangible personal property located outside California | Not taxable |
| Gain on the sale of real property or tangible personal property located in California | Taxable |
| Interest and dividends | Not taxable[2] |
| Wages for services performed in California | Taxable |
| Wages for services performed outside California for a California business, trade, or profession | Not taxable |
| Sole proprietor's receipts for services performed for California businesses | Apportionable[3] |
| Pensions accrued during California residency from services performed in California | Not Taxable |
| Income from a stock option exercised after taxpayer becomes a nonresident but where services between grant date and exercise date were performed while taxpayer was a resident | Taxable[4] |
| California-source income from California S corporation or partnership | Taxable |
| Gain on sale of partnership interest or closely held stock in a California corporation | Not taxable[5] |
| Income from royalties and for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, etc., that have a business situs in California | Taxable |
| Payments on installment sale of intangibles sold while a resident | Taxable |

[1] If the income is an integral part of a unitary business, it would be taxable, and you would need to use California's single-sale apportionment formula and market-based sourcing rules to determine the portion allocable to California (18 Cal. Code Regs. §17951-4(c))

[2] Interest and dividend income would not be taxable unless it had a business or taxable situs in California (R&TC §17952) or unless the intangible income is from an installment sale that occurred while the taxpayer was a resident

[3] ***Appeal of Bindley*** (May 30, 2019) 2019-OTA-179P

[4] 18 Cal. Code Regs. §17952

[5] ***Appeal of Amyas Ames, et al.*** (June 17, 1987) 87-SBE-042

# INCOME REPORTING REQUIREMENTS FOR MILITARY SERVICEMEMBERS AND CIVILIAN SPOUSES

| **Income reporting requirements (when qualified under the MSRRA and residing in California)** | |
|---|---|
| **M = Military Servicemember; S = Spouse** | |
| **M –** Domiciled in a community state (other than California) and stationed in California all year<br><br>**S –** Domiciled in same community property state as M and resided in California all year | If filing a joint return, file Long or Short Form 540NR. Report all income, including military income, on Schedule CA (540NR), Column A, or on Short Form 540NR, line 13. Report all military income in Column B, or Short Form 540NR, line 14. Report all California-source income in Column E, or Short Form 540NR, line 32 (do not include intangible or non-California-source income).<br><br>If filing separate returns, M and S must file Long Form 540NR. Report on Schedule CA (540NR), Column A, all separate income and one-half share of community income, including one-half share of military income. Enter one-half share of military income in Column B. Report all separate California-source income and one-half of California-source community income in Column E (do not include military or intangible income). |
| **M –** Domiciled in a separate property state and stationed in California all year<br><br>**S –** Domiciled in the same separate property state as M resided in California all year | If filing a joint return, file Long or Short Form 540NR. Report all income, including military income, on Schedule CA (540NR), Column A, or on Short Form 540NR, line 13. Enter all military income in Column B or on Short Form 540NR, line 14. Report all California-source income in Column E or on Short Form 540NR, line 32 (do not include military or intangible income).<br><br>If filing separate returns, M must file Long Form 540NR. Report on Schedule CA (540NR), Column A, all separate income, including all military income, M's intangible income, California-source income and non-California-source income. Enter in Column B all M's military pay. Report in Column E all of M's California-source income (do not include military or intangible income). If M has no California-source income, M does not have to file a California return.<br><br>If filing separate returns, S must file Long Form 540NR. Report on Schedule CA (540NR), Column A, all separate income, including S's intangible income, California-source income and non-California-source income. Report in Column E all of S's California-source income (do not include earned income). If S has no California source income, S does not have to file a California return (except to request refund of California income tax withheld). |

# CASES

## GENERAL

Taxpayers who regularly spent eight to nine months a year in California and had substantial business interest in California were residents. The court defined residence as bodily presence as a nontransient inhabitant rather than domicile. (***Whittell v. Franchise Tax Board*** (1964) 231 Cal.App.2d 278)

Even though the taxpayers spent considerable time and owned a home in California, they remained residents of another state where they had significant contacts. (***Fred C. Klemp v. Franchise Tax Board*** (1975) 45 Cal.App.3d 870)

When a person lives a part of the time in California and a part of the time elsewhere and has his closest business or other connections elsewhere, he is not a resident of California. (***Appeal of David E. and Dolly D. Bright*** (July 22, 1958) 58-SBE-021)

Where a person became a resident of California and thereafter divided his time between California and other states, he remained a California resident in the absence of a showing that he ever left California for other than temporary or transitory purposes. (***Appeal of Joseph P. and Mary Joy Tarola*** (January 5, 1965) 65-SBE-001)

A taxpayer was a resident of California, not merely a vacationer, when she bought a house in this state and spent most of her time in California over a four-year period, delaying her departure for business reasons, the illness and death of her brother, and a possible will contest. (***Appeal of Katherine Strickler Hill*** (September 15, 1958) 58-SBE-025)

A taxpayer was a resident when she spent eight and one-half months per year in California while her daughter attended school in California. (***Appeal of Jeanette D. Silverthorne*** (December 13, 1961) 61-SBE-074)

A student who attended college in California for more than nine months each year was not a resident when she showed that she had paid nonresident tuition fees and had remained in California only long enough for her education and had returned to the state of her domicile immediately thereafter. (Legal Ruling 122 (December 5, 1958))

An airline pilot owned a house in California and a condo in Nevada. After reviewing his canceled checks and credit card charges, the FTB determined that he paid physicians and dentists, paid for veterinary services at a pet clinic, received haircuts, got his clothes professionally cleaned, purchased gasoline, had his car repaired, and ate in restaurants in California. He was therefore a resident of California. (***Appeal of John E. Young*** (November 16, 1986) 86-SBE-199)

***Comment***

Affidavits or testimony of an individual and of friends, employer, or business associates that the individual was in California for a rest or vacation, to complete a particular business transaction, or to work for a limited period of time will be sufficient to overcome any presumption of residence. In the case of individuals who claim to be nonresidents by virtue of being outside the state for other than transitory purposes, affidavits of friends and business associates as to the reasons for being outside the state should be submitted. (18 Cal. Code Regs. §17014(d)(1))

## EXAMPLES OF SEAMEN WHO WERE RESIDENTS

If a merchant seaman is married and the spouse is a California resident, the seaman is generally going to be held to be a resident.

A California merchant seaman who works at sea for large portions of the year but who maintains a domicile in the state is still considered a resident. (***Appeal of Morgan P. Dailey and Marcelle M. Burke*** (September 14, 2000) Cal. St. Bd. of Equal., Case No. 26800) The taxpayer worked as a merchant seaman in 75-day rotations, while the spouse lived in Clovis and attended Fresno State (and paid resident tuition). They claimed the husband's tax home was the homeport of the ship or his employer, both of which were outside California. The Board ruled that the taxpayer's time at work was transitory and that no evidence was presented to suggest that a domicile had been established anywhere else but the home in Clovis.

A ship's engineering officer remained a California resident while at sea because he maintained substantial connections in California. The ship's homeport was California, and he belonged to a local union. He stored personal property in California and maintained his mailing address and bank accounts in California. The fact that he did not have a family home in California or vote or own a car registered in the state did not make him a nonresident. (***Appeal of Edmund J. Rogers*** (March 8, 1976) 76-SBE-026)

## EXAMPLES OF SEAMEN WHO WERE NOT RESIDENTS

***Comment***

In the cases discussed below, where the merchant seamen were held to be nonresidents, the seamen were not married. When a seaman has a family home or a spouse in California to which he returns periodically, he is invariably held to be a resident.

A seaman who was domiciled in California was not a resident for income tax purposes because he was outside of the state for other than a temporary or transitory purpose. He didn't need to establish a residency in another state or country to prove he was not a California resident. He presented evidence establishing that he had neither a wife nor dependents living in California; maintained no permanent residence in California; was away from California approximately 90% of the time; owned no real property in California; and kept neither a car nor other personal property in California. (***Appeal of Richard W. Vohs*** (September 17, 1973) 73-SBE-05)

A merchant seaman was a nonresident because his connections with California were minimal, the benefits he received from the state were insufficient to classify him as a resident and his absences from California were for other than temporary or transitory purposes. Although he worked for California shipping companies, he owned real property and maintained bank accounts in other countries, held a Hawaii driver's license, and spent time in France and England. The fact that each of his absences was for a short time did not establish that they were for temporary or transitory purposes; the length of a taxpayer's absence from California is not persuasive of residence. (***Appeal of Thomas J. Tuppein*** (May 4, 1976) 76-SBE-058)

## EXAMPLES OF CHANGES IN DOMICILE

California domicile of a taxpayer terminated when his real estate was sold or leased, bank accounts closed, notice was given to clubs and business associates, and he actually departed from California. (***Appeal of Estate of Eleanor M. Gann, Deceased, Bank of America NT & SA, Executor*** (December 13, 1971) 71-SBE-036)

Where the husband retained his intention to return to his wife in California throughout his overseas employment, he continued to be a domiciliary of California. Thus, his income was community property, one-half of which was taxable to his wife, who continued to be a resident of California. (***Appeal of Robert M. and Mildred Scott*** (March 2, 1981) 81-SBE-020)

The Board cited as precedent that the FTB's determination of residency is presumptively correct (***Appeal of John R. Young*** (November 19, 1986) 86-SBE-199) and that in the event of doubt about a question of domicile, it is presumed not to have changed. (***Whitmore v. Comm.*** (1955) 25 TC 293; ***Appeal of Anthony J. and Ann S. D'Eustachio*** (May 8, 1985) 85-SBE-040) The indicators of residency did not weigh heavily enough in the taxpayer's favor to overcome the presumptions found in the Board's precedents. The taxpayers won with respect to one of the four years in question and lost the other three.

A taxpayer who traveled to and worked in Arizona for approximately six months, during two consecutive years, remained a California resident. He lived in California prior to and subsequent to his trips to Arizona, staying in Arizona only during the course of his employment. As a result, the Board found his absence from California was for a temporary purpose, and he remained a California resident at all times in question. (***Appeal of James P. Simpson*** (December 14, 2004) Cal. St. Bd. of Equal., Case No. 250415)

## EXAMPLES OF ABSENCE FOR TEMPORARY PURPOSES

Taxpayers were out of California for temporary or transitory purposes and therefore retained their California residency during their absence when the husband initially went to Europe to direct a motion picture under a 16-week employment contract, subsequently made three additional films over a three-year period, and where the couple kept their California home vacant and occupiable during their entire absence. (***Appeal of Nathan H. and Julia M. Juran*** (January 8, 1968) 68-SBE-004)

A schoolteacher on sabbatical leave who travels to another state remains a resident. (***Appeal of Wilfred A. and Betty J. Meacham*** (August 19, 1975) 75-SBE-055) (The taxpayer may be a nonresident if absence met the employment-contract criteria in R&TC §17014.)

A taxpayer who spent approximately 10 months in Australia was held to be a resident. He was not allowed to deduct his living expenses while away from California because his "tax home" was considered to be the place of his employment, which was Australia. (***Appeal of Harold L. Benedict*** (January 5, 1982) 82-SBE-002)

## EXAMPLES OF ABSENCE FROM THE STATE FOR OTHER THAN TEMPORARY OR TRANSITORY PURPOSE

Because the taxpayers had severed all California ties and had intended to remain in the Mideast indefinitely, they were nonresidents for the period in question although they were actually absent from the state less than four months. (***Appeal of Christopher R. and Hoda A. Rand*** (April 5, 1976) 76-SBE-092)

Although the taxpayer was absent from California for only seven months, his intent at the time of leaving was to stay permanently. He severed his business and social ties and separated from his wife with no intent to reconcile. After he did return to California, he did not return to his wife and home for more than a year. (***Appeal of James E. Duncan*** (January 5, 1982) 82-SBE-006)

A professional writer, who was a resident of California before he went to England to write a screenplay, was not a California resident during his absence from the state. Although his assignment was canceled and he returned to California, he had intended to remain in England indefinitely. He bought a

one-way ticket to England, enrolled his daughter in an English school, and retained professional services there. (***Appeal of Richard L. and Kathleen K. Hardman*** (August 19, 1975) 75-SBE-052)

## EXAMPLES OF PRESENCE IN STATE FOR OTHER THAN TEMPORARY OR TRANSITORY PURPOSE

Comparison of two taxpayers' business ties, home, and time spent in California with that in Illinois, their previous residence, showed the closest connections with California. (***Appeal of Jerald L. and Joan Katleman*** (December 15, 1976) 76-SBE-110)

The taxpayers were residents of California because of their business efforts and social contacts in the state, their personal residence and children were in California, and the greater number of their other residency contacts were in California. (***Appeal of Beldon R. and Mildred Katleman*** (October 17, 1980) 80-SBE-127)

When taxpayers come to California uncertain whether or when to leave, they will be considered to have come for an indefinite period and will therefore be residents for income tax purposes. (***Appeal of George W. and Gertrude Smith Davis*** (April 20, 1964) 64-SBE-087)

The taxpayer was a California resident when he spent substantially more time in California than in Nevada, where he claimed residence. In addition, his house in California was more substantial than his Nevada house, he had a telephone and post office box in California and none in Nevada, his health prevented long stays in Nevada, he bought a California resident hunting license, and he listed himself as a California resident on an employment form. (***Appeal of Ty Cobb*** (March 26, 1959) 59-SBE-014)

Taxpayers who planned to move to Colorado on March 1, 1994, but did not actually move until July 1994, were residents of California and, therefore, liable for $151,632 in California tax on stock they sold on March 7 and March 25, 1994. (***Homer Noble, et al. v. Franchise Tax Board*** (May 11, 2004) 118 Cal.App.4th 560)

## EXAMPLES OF NONRESIDENTS

Although the taxpayers spent more time in California than they did in Illinois, they did not become California residents. Their primary connections were in Illinois through business, voting, motor vehicle registrations, banking, and professional services. Their only contacts with California were as visitors during the winter months and as property owners and club members. (***Fred C. Klemp v. Franchise Tax Board*** (1975) 45 Cal.App.3d 870)

Taxpayers who purchased a home in California and each winter spent six to six and one-half months in it, but retained all business and social connections in Illinois, where they spent the rest of the year, and listed Illinois as their residence for voting, federal income tax, and passport application purposes, were not residents of California for income tax purposes. Their contacts with California were of a temporary or transient nature. (***Appeal of Sherman*** (August 6, 1962) 62-SBE-043)

## EXAMPLES OF RESIDENT WITH NONRESIDENT SPOUSE

The wages of a taxpayer who is domiciled in California are community property, even if the taxpayer is residing and working in another country. The wife was living and working in California, while her husband was living and working in Taiwan. Although the husband was not a California resident, the Board found that he was still domiciled in California. As a result, the wife was liable for tax on her community share of her nonresident husband's foreign earnings and he was liable for tax

on his community share of her California earnings. (***Appeal of Sam M. and Julie C. Yeh*** (April 12, 2005) Cal. St. Bd. of Equal., Case No. 267572)

When one spouse is a resident of California and the other spouse is domiciled in another state or country, the status of the husband's earnings as community or separate property is determined by the laws of the other state or country. If the other state or country considers these earnings to be community property, the wife must report her share of the community earnings on her separate California income tax return. However, if the husband's earnings are considered his separate property, then the wife need not report them. (***Estate of Eleanor M. Gann*** (December 13, 1971) 71-SBE-036)

Where the husband was a resident of Washington, a community property state, and the wife continued to be a California resident, one-half of the husband's income was subject to California income tax as the wife's income, despite the fact that his wife was domiciled in Washington. (***Appeal of Herrman*** (August 6, 1962) 62-SBE-041)

The taxpayer left California in 1974, worked in Alabama for 18 months and then returned and resumed living with his wife and children, who had remained in California. The taxpayer was held to be a California domiciliary but not a resident, and his Alabama income was community property, one-half of which was taxable to his wife. (***Appeal of Nancy B. Meadows*** (October 28, 1980) 80-SBE-132)

## SALE OF STOCK

The gain realized from the sale of stock was subject to California tax when the gain did not accrue prior to the taxpayers becoming California residents. (***Appeal of Jerald L. and Joan Katleman*** (December 15, 1976) 76-SBE-110)

When a nonresident sells real property located outside California but becomes a resident before escrow closes, the entire gain is taxable by California. (***Appeal of Estate of Albert Kahn (Dec'd) and Lillian Kahn*** (April 9, 1986) 86-SBE-077)

## PARTNERSHIP AND S CORPORATION CASES

Income received by a nonresident limited partner from a partnership doing business in California is taxable by this state as California-source income. (***Appeal of George D. Bittner*** (October 9, 1985) 85-SBE-111)

A partnership headquartered in La Jolla was involved exclusively in long-term investments that were purchased and sold mainly through a trading room in Fort Worth, Texas. The income was not taxable to nonresident partners. (***Appeal of Robert M. and Ann T. Bass, et al.*** (January 25, 1989) 89-SBE-004)

Sale of a partnership interest by a nonresident individual is the sale of an intangible and therefore not subject to California tax, even when the main asset of the partnership was real estate located in California. (***Appeal of Amyas and Evelyn P. Ames, et al.*** (June 17, 1987) 87-SBE-012)