California Taxation of New Residents and Nonresidents

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CALIFORNIA TAXATION OF NEW RESIDENTS AND NONRESIDENTS

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. (Cal. Code Regs. §17014(a); ***Whittell v. Franchise Tax Board*** (1964) 231 Cal.App.2d 278, 231 Cal.App.2d at p. 285)

➪ ***See page Appendix 8***

"Checklist to help determine California residency/nonresidency"

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.

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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. His wages are not 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.

The 546-day rule

A taxpayer who qualifies as a nonresident under R&TC §17014(d) — commonly called the 546-day rule — is a nonresident of California, but still domiciled in California, which means community property applies. See below for more information.

Here's a common scenario.

> ***Example of nonresident spouse domiciled in California***
>
> Jim and Jane are married. Jim goes to Saudi Arabia under a written two-year contract while Jane stays and works in California. Jim is a nonresident so his wages are not taxable to California. However, half of his wages belong to Jane and as a resident she is taxed on 100% of her income. Her wages are community property as well. They are all taxable to California because they were earned in California.

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))

Note

In these situations, the taxpayer is likely still domiciled in California but is a nonresident.

➪ ***See page Appendix 10***

"California nonresidency and employment contract provisions"

Failing the test

If an individual domiciled in California is working outside the state for fewer than 546 consecutive days or 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)

A taxpayer left California in January 1996 to fulfill a one-year teaching contract in South Korea. The taxpayer argued that his intent was to stay in South Korea indefinitely, but that he was forced to return to California at the end of his initial contract because he was losing too much money. The Board stated that even in situations where employment assignments are indefinite but the taxpayer does not establish a new residence, the assignment will be considered for temporary or transitory purposes.

In this case, not only was the employment contract for a definite period of time (less than 546 days), but also the taxpayer did not establish a new residence in South Korea and he maintained some ties with California. Based on these facts, the Board held that the taxpayer had not established that he changed his domicile or residence from California to South Korea in 1996.

Failing the 546-day 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.

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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 may not be 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.

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 which 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, prior to the year in question, he had been a part-time California resident, and during the year in question he was 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.
- 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 RESIDENCE

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)

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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.

Hyatt: The tax case that just won't quit

In 1993, the FTB began a residency audit questioning Gilbert Hyatt's 1991 change of residence and domicile from California to Nevada.

Hyatt was a longtime resident of California. He alleges he sold his home and relocated to Nevada, abandoning his California residence and domicile, thus avoiding California tax on $40 million of patent licensing income.

When the FTB began its expected audit, the auditor used extremely aggressive tactics, including sending letters to and speaking with Hyatt's neighbors, going through his trash, and using other methods of discovering Hyatt's true residence and domicile. This resulted in a lawsuit against the FTB alleging fraud, intentional infliction of emotional distress, abuse of process, breach of confidential relationship, and invasions of privacy.

Even when the civil case is settled, there is still the question of Mr. Hyatt's residency in 1991 and 1992. The residency case continues, with both the taxpayer and the FTB accusing each other of foot-dragging and many other indiscretions.

Briefs have been submitted to the Board of Equalization in the residency case, and both sides have gone public with facts contained in the briefs, but the case has never been heard by the Board.

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 only ever rented 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 time 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.

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.

Amending tax return

Taxpayers were able to successfully prove the husband moved from California to Arizona in August of the tax year in question, and therefore his wages from August 1 through December 31 were not taxed by California. (***Appeal of Erickson*** (April 24, 2013) Cal. St. Bd. of Equal., Case No. 556308) The issue arose when the taxpayers mistakenly filed a California resident tax return rather than a California nonresident/part-year resident return and did not include the wages earned in Arizona on the return.

The Board found that the taxpayers had provided convincing evidence, including a lease agreement in Arizona that the husband had moved to Arizona on August 1 and ceased to be a resident of California on that date.

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.

HOW DOES A TAXPAYER BECOME A NONRESIDENT?

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 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.

Medical licenses aren't enough

A California taxpayer was found to be a resident of California, even though she was living out-of-state for the tax year in question and held medical and driver's licenses in New Jersey and Ohio. (***Appeal of Cooper*** (May 22, 2013) Cal. St. Bd. of Equal., Case No. 570236)

The taxpayer's husband continued to live in California during her absence, and did not show any indication that he was planning on leaving California to join her.

This fact weighed heavily against the taxpayer; the Board noted that they have continually held "in instances when a person leaves California for employment reasons, the fact that the person's spouse remained in California was a significant factor in demonstrating that the taxpayer was benefiting from the laws and government of California."

However, this is just one factor that can make it difficult to establish nonresidency.

The taxpayer maintained her acupuncturist license in California, and she used a California address on her New Jersey medical license and on her federal and state tax returns (which were prepared by a California tax service). These factors also, unfortunately, pointed toward her maintaining her California residency.

The actions that the taxpayer argued proved her residency in Ohio and New Jersey — renting apartments, holding medical and driver's licenses, and paying taxes in the other states — were related to her transient employment and would have been necessary whether she was staying in those states permanently or not.

➪ ***See page Appendix 8***

"Checklist to help determine California residency/nonresidency"

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.

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Marital property rights in personal property are determined by the law of the domicile of the acquiring spouse. These are the community property states (and U.S. territories):

- Alaska*
- Arizona
- California
- Idaho
- Louisiana
- Nevada
- New Mexico
- Texas
- Washington
- Wisconsin
- Puerto Rico
- Commmonwealth of Northern Marianna Islands

* 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.

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)

Where a husband retained California domicile but had his residence outside the state, his earnings were community property. Because his wife was a California resident, she was required to report one-half of her husband's earnings. (***Appeal of Bailey*** (March 8, 1976) 76-SBE-016)

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, the Head of Household 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.

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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.

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

Nonresident spouse's income was community property

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 Court has determined that the state where the spouse is domiciled when personal property is acquired or earned will govern the nature of the property (i.e., whether such property should be treated as community property or separate property). (***Schecter v. Sup. Ct. of Los Angeles County*** (1957) 49 Cal.2d 3) Because Arizona law states that all property acquired by either husband or wife during the marriage is the community property of the husband and wife, the husband's income in this case is community property.

For California personal income tax purposes, that income constituted "gross income" to the wife, which is taxable by California, because she was a resident of California.

➩ ***See pages Appendix 2 and Appendix 3***

"How to split income on Form 540NR" and
"Income taxability chart for resident taxpayer with nonresident spouse"

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.

Note

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.

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

California work days from date of grant to date of exercise / Total work days from date of grant to date of exercise	=	Allocation ratio
Allocation ratio × Total stock option income	=	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

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.

> ***Note***
>
> This would be an aggressive, but potentially successful, position.

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.

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.

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: • Wage income is taxable by CA; and • Possible Other State Tax Credit.	…on the date you exercise your NSO: • Wage income is taxable by CA to the extent you performed services in CA from the grant date to the exercise date; and • Possible Other State Tax Credit.
	…on the date you sell the stock: • Capital gain is taxable by CA.	…on the date you sell the stock: • Capital gain is not taxable by CA.
Incentive stock option (ISO)	…on the date you exercise your ISO: • AMT adjustment is made if you do not sell the stock in the year of exercise; and • Increase your AMT basis by the AMT adjustment.	…on the date you exercise your ISO: AMT adjustment is made if you do not sell the stock in the year of exercise; • AMT adjustment is included to the extent you performed services in CA from the grant date to the exercise date; and • Increase your AMT basis by the AMT adjustment.
	…on the date you sell the stock in a qualifying disposition at a gain: • Capital gain is taxable by CA; and • Possible AMT credit.	…on the date you sell the stock in a qualifying disposition at a gain: • Capital gain is not taxable by CA; and • Possible AMT credit.
	…on the date you sell the stock in a disqualifying disposition: • Wage income and capital gain (if any) are taxable by CA; • Possible Other State Tax Credit; and • Possible AMT credit.	…on the date you sell the stock in a disqualifying disposition: • Wage income is taxable by CA to the extent you performed services in CA from the grant date to the exercise date; • Capital gain (if any) is not taxable by CA; • Possible Other State Tax Credit; and • Possible AMT credit.
		(continued)

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Table of Taxation of Stock Options *(continued)*

Type of stock option	If you are a California resident…	If you are a California nonresident…
Employee stock purchase plan (ESPP)	…on the date you sell the stock in a qualifying or disqualifying disposition at a gain: • Ordinary income and capital gain are taxable by CA; and • Possible Other State Tax Credit.	…on the date you sell the stock in a qualifying or disqualifying disposition at a gain: • Ordinary income is taxable by CA to the extent you performed services in CA from the grant date to the exercise date; • Capital gain (if any) is not taxable by CA; and • Possible Other State Tax Credit.
California qualified stock option (CQSO)	…and R&TC §17502 provisions are met: • Same tax treatment as ISO.	…and R&TC §17502 provisions are met: • Same tax treatment as ISO.
	…and R&TC §17502 provisions are not met: • Same tax treatment as NSO.	…and R&TC §17502 provisions are not met: • Same tax treatment as NSO.
Restricted stock option (RSU)	…on the date the option vests: • Wage income is taxable by CA; and • Possible Other State Tax Credit.	…on the date the option vests: • 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 • Possible Other State Tax Credit.
	…on the date you sell the stock: • Capital gain is taxable by CA.	…on the date you sell the stock: • 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.

Example of new resident withdrawing an IRA

Millie B. moved to California on December 31, 2009. She had contributed $2,000 each year to her IRA in 1984 and 1985 only. She had never taken any distributions from her IRA, and it had a value of $20,000 on the day she became a California resident.

Millie takes a $12,000 distribution from her IRA of the current year. For California purposes, her basis is calculated as if she had been a resident of California for all prior years. If Millie was covered by a pension plan in 1984 and 1985, her IRA contributions would have been nondeductible under California law. Thus, her basis is $4,000 ($2,000 × 2 years). She is taxed on $8,000 of income ($12,000 - $4,000).

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?

Contribution to 401(k) not treated as basis

A taxpayer was not permitted to treat tax-deferred contributions to her 401(k) plan as basis when computing her California tax liability for the 1998 taxable year. (***Appeal of Ching-I and Pih-Kuei Huang*** (2004) Cal. St. Bd. of Equal., Case No. 185996)

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.

For 2011 and later, the taxpayer must report income to California if he or she 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.

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 mid-year 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 mid-year 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. State 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 AND EXCHANGES 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.

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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

Beginning in the 2015 taxable year, a taxpayer must carry back 100% of the loss to 2013. The taxpayer may elect to carry the loss forward. It would seem that a taxpayer becoming a nonresident would benefit from the carryback assuming the taxpayer will not have California-source income in the future.

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)

Sourcing rules for nonresident service businesses

Because of the passage of Proposition 39, the computation changes for even small multistate businesses, including Schedule C businesses that must also use the single sales factor.

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. (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 57 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.

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)

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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; SB 401 (Ch. 10-14); 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 last year's book of business. Whether the income is taxable to California and subject to withholding depends on:

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

There are different rules for agents who sold exclusively life insurance and those who sold life as well as other types of insurance. (FTB Legal Ruling 2011-02 (February 25, 2011))

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))

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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.

Note

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)

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.

CANCELLATION OF DEBT

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.

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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)

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, as would be the case if employed in operating trains, boats, motor buses, trucks, etc., between California and other states and foreign countries, and are paid on a daily, weekly, or monthly basis, 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.

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)

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.

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> ***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 a 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. (E-mail from the FTB, dated May 1, 2014) 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 follows.

State	Promo events	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 $2,250,000, plus a bonus of $900,000 for winning.

There were 1 million total viewers and $45 million in proceeds. The breakdown of PPV subscriptions was as follows:

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)) R&TC §25137 and 18 Cal. Code Regs. §25137-8.2 provide specific rules concerning the amount of business income from sources within California with respect to income from "cable television services."

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 $3,150,000 ($2,250,000 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 $2,500,000 in proceeds from PPV subscriptions, plus a bonus of $1,000,000 for winning.

There were 1 million viewers and $50 million in proceeds. The breakdown of PPV subscriptions for this Nevada event was as follows:

State	Percentage of total viewers
California	35%
New York	30%
Texas	20%
Nevada	10%
Other	5%

John's income will be $0 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 page Appendix 11***

"California income: taxable or not taxable to a nonresident"

COMPUTING THE TAX

Use Schedule CA (540NR) for nonresidents and part-year residents who must file Form 540NR. On this form, taxpayers (except active duty nonresident members of the military) will enter each item from Page 1 of IRS Form 1040 line by line. There are columns for:

- Total income from all sources as reported on the Form 1040;
- Subtractions from federal income;
- Additions to federal income;
- Total income calculated under California rules;
- The amount taxable to California; and
- The tax is computed based on a proration of California-source income to all source income.

Note

Nonresident military members must recompute their federal income excluding the non-California active duty military income.

CALIFORNIA METHOD OF COMPUTING TAX

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: 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: 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: 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)

Example of tax computation

Tom was a resident and domiciliary of Washington until March 31. He became a California resident on April 1. Tom earned and received wages of $15,000 in Washington while he was a Washington resident, and he earned wages of $65,000 while he was a California resident. Tom also earned $4,000 in interest income during the year: $1,000 while a resident of Washington and $3,000 while a California resident.

Tom is single and had the following itemized deductions:

Real estate taxes	$ 1,200	(CA house)
	800	(WA house)
Mortgage interest	17,000	(CA house)
	3,500	(WA house)
Charitable contributions	1,500	(NY Firefighters' Fund)
	$24,000	

Note: The source of the deduction is irrelevant because the total deductions are prorated based on California AGI to total AGI.

Calculation of Tom's California tax liability:

CA AGI	$65,000	(CA wages)
	+ 3,000	(Interest earned while a CA resident)
	$68,000	
Total AGI	$80,000	(Wages from all sources)
	+ 4,000	(Interest income from all sources)
	$84,000	
CA itemized deductions	$24,000	(Total itemized deductions)
	× .8095	(CA AGI ÷ Total AGI)
	$19,428	
CA taxable income (TI)	$68,000	(CA AGI)
	- 19,428	(CA itemized deductions)
	$48,572	
Total taxable income (TI)	$84,000	(Total AGI)
	- 24,000	(Total itemized deductions)
	$60,000	
Tax on total taxable income	$ 3,057	(Tax table*)
	× .8095	(CA TI ÷ Total TI)
	$ 2,475	
Prorated exemption credit	$ 109	(Personal exemption credit*)
	× .8095	(CA Taxable Income ÷ Total TI)
	$ 88	
CA tax liability	$ 2,475	(Prorated tax)
	- 88	(Prorated exemption credit)
	$ 2,387	

* For purposes of this example, the 2015 Tax Table and personal exemption credit amounts have been used.

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:

- Taxpayers who lived in Nevada, but the husband worked in Los Angeles, incorrectly subtracted the wife's Nevada-source income and gambling winnings from their Form 540NR. (***Appeal of Hill*** (September 23, 2014) Cal. St. Bd. of Equal., Case No. 742683)
- 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.
- A taxpayer did not report Connecticut-source income to California, arguing that he had already paid tax to Connecticut on that income and did not earn any California-source income after moving. (***Appeal of Sun*** (September 23, 2014) Cal. St. Bd. of Equal., Case No. 716472)

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, Indiana, Oregon (see exception below), Virginia	Other state nonresident return
	Any state or U.S. possession not listed above	California resident tax return
Taxpayer is:	**Resident of:**	**Credit is taken on:**
California Nonresident	Arizona, Guam, Indiana, Oregon, Virginia	California nonresident tax return
	Any state or U.S. possession not listed above	Other state resident return
Source: R&TC §§18001, 18002; 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.

Exception for taxes paid to Oregon

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.

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 2008, 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 claim an OSTC with the FTB, notwithstanding any other statute of limitations. (R&TC §19311.5)

Missed OSTC on other state's return can't be taken on CA return

A taxpayer who incorrectly filed resident return rather than nonresident return was held liable for California tax. (***Appeal of Calvin*** (November 19, 2014) Cal. St. Bd. of Equal., Case No. 729341) The taxpayer argued against the California Method of using worldwide income to arrive at the rate of tax which is applied against California-source income. He also argued that the FTB was barred from assessing additional tax because the statute of limitations for filing an amended Pennsylvania return had passed, and he would be unable to recoup the double tax. The California Method of taxing nonresidents is valid, and the taxpayer was not entitled to the Other State Tax Credit for increased liability because the statute of limitations to claim an Other State Tax Credit had lapsed in Pennsylvania. Where a taxpayer fails to take the OSTC in another state to prevent double taxation and then the statute has run, the double tax cannot be recouped under the California statute. (See ***Appeal of Curtain*** (July 14, 1943) 43-SBE-015)

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

According to the FTB, the Revised Texas Franchise Tax is not a "net income tax," and therefore it does not qualify for California's Other State Tax Credit (TAM 2016-01) The FTB is disallowing the OSTS for the Revised Texas Franchise Tax.

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 Board of Equalization) 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.

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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.

Note

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 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, $3,000 of California withholding taxes, $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	$2,000	
California withholding tax	3,000		
Mortgage interest	10,000	10,000	
Miscellaneous	3,000	3,000	
2% reduction miscellaneous	(2,900)	(1,900)[1]	
Itemized deductions	$15,100	$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 stationed 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.

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) The taxpayer argued that Florida was his "home of record" and that the military recognized Florida as his home. Prior to his retirement, he continued to jointly own a home in Florida, he paid property taxes in Florida, and he was unsure that he would remain in California. The Board determined he was a California resident because the taxpayer had been employed in California for six years, he had voted in California, two of his automobiles were registered in California, and the majority of his belongings had been moved from Florida to California.

➪ ***See pages Appendix 12 and Appendix 13***

"Income reporting requirements for military servicemembers and civilian spouses" and "Cases"

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 53.)

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.

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.

MARKET-BASED SOURCING

Beginning in 2013, 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

On February 27, 2012, the FTB filed regulation §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.

Example of assigning sales

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, the 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.

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.

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))

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.

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.

> ***Note***
>
> In the 2011 and 2012 taxable years, corporations could elect to use a single sales factor in the apportionment formula, or the previous four-factor formula.

> ***Example of a 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.

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)

How to file a group return

The entity must attach Form FTB 3864, Group Nonresident Return Election, with the entity tax return (Form 100S, 565, or 568) and to the group nonresident return (Form 540NR). The entity also must attach Schedule 1067A, Nonresident Group Return Schedule, to the group nonresident return. Nonresident individual elections are made on an annual basis. Once the return is filed, the election is irrevocable for the taxable year.

The tax rate applicable to each electing individual's distributive share is the highest marginal rate (currently 12.3% or 13.3% for individuals with income in excess of $1 million). No deductions are allowed except those necessary to determine each individual's distributive share, and no credits are allowed except those directly attributable to the entity. The entity, as agent for the electing individuals, must make the payments of tax, additions to tax, penalties, and interest.

The business entity must inform nonresident individuals of the terms and conditions of filing a group return as specified on Form FTB 3864. (FTB Publication 1067)

Corporate directors report on the group nonresident return their director's wages, salaries, fees, or other compensation from the corporation for director services performed in California, including attendance at board of directors' meetings in California. Rules for allocating wages, salaries, and other compensation to determine the amount attributable to California are in 18 Cal. Code Regs. §17951-5.

An S corporation that has both electing nonresident directors and nonresident shareholders must file only one group nonresident return, including both directors and shareholders.

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.

Estimated tax payments

Estimated tax payments are required if the net tax on the group return is $500 or more. If the tax is underpaid, the entity must attach Form FTB 5805, Underpayment of Estimated Tax by Individuals and Fiduciaries, to the group return and pay any applicable penalties. For purposes of estimated tax filing thresholds, requirements, exceptions, and penalties, a group return is treated as if it were a single individual return under R&TC §19136.

If a business entity files and pays estimated tax payments on behalf of an individual who opts out of participating in a group return, then the entity can make a request to the FTB to have that individual's estimated tax payments moved to his or her individual account. In addition, an individual can make a request to move estimated tax payment amounts in his or her individual account to a group account. See FTB Publication 1067, Guidelines for Filing a Group Form 540NR, for the FTB mailing address and information to include in the request.

The entity pays estimated tax by filing FTB Form 540-ES, Payment Voucher of Estimated Tax for Individuals. The entity must file the voucher using its name and federal identification number and type or print in the top margin: "GROUP FILING PROGRAM MS L170 ATTN: IVS (732)."

Filing and paying estimated tax does not relieve the entity from the withholding requirements pertaining to the income and/or distributions allocable to nonresident partners or LLC members under R&TC §§18662 and 18666. However, the FTB generally grants a waiver if the individual participates in a group return. Waivers are handled by the FTB on a case-by-case basis by filing FTB Form 588, Nonresident Withholding Waiver Request. Either the individual or the entity can file FTB Form 588.

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.)

Example of individual rental

Jeff rents a residence from John Q. Nevada, paying $1,000 per month in rent. He is not required to withhold tax on the rent he pays John.

If Jeff paid rent to Property Managers, Inc. for his residence, Property Managers would be required to withhold on the rent paid to John Q. through them. Assuming Property Managers charges John Q $100 per month, Property Managers would be required to withhold on 7% of $900 ($1,000 - $100).

Example of business rental

James is a self-employed architect and rents an office from Mary Q. Arizona, paying $2,000 per month in rent. James must withhold 7% of each month's payment for rent on his business property and forward that withholding to the FTB.

Different definitions of California-source business income

The use of California-source income for apportionment purposes is different than California-source income for withholding-at-source purposes.

For apportionment purposes, service revenues of a trade or business are sourced according to where the benefit is received under 18 Cal. Code Regs. §25136-2.

However for withholding-at-source for nonresidents, the focus is on where revenues for personal services performed by an individual should be sourced. Under 18 Cal. Code Regs. §17951-5, personal service revenues are sourced where the service is performed. So if a nonresident performs personal services in California for a business, then the business must withhold 7% from the payments made to the nonresident for those services performed in California.

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Example of sourcing revenue

MySource, Inc. provides online, personalized meditation services for tax practitioners over the Internet. From its billing records, it is able to tell where its customers receive the benefit of its services. Let's say for the month of April, 200 customers from five states (for simplicity, 40 customers in each state) subscribed to these services. For California apportionment purposes, MySource, Inc. would source 20% of its revenues to each of those states.

MySource, Inc. hired Sally Nirvana, a Hawaii resident, as an independent contractor to perform some of these meditations and to train other meditation leaders. In April, she came to MySource, Inc.'s headquarters in Santa Cruz, California, to conduct a seminar. She was paid $10,000 for the personal services she performed in Santa Cruz and $5,000 for work she performed in Hawaii, putting together the reports and doing telephone follow-ups for MySource. MySource must withhold $700 from this payment ($10,000 × 7%).

Withholding also applies to payments made to nonresidents for:

- Leases;
- Rents;
- Royalties;
- Winnings; and
- Payouts.

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.

No withholding is required if services or income is from other-than-California sources.

California-source income only

Withholding is only required on California-source income. Thus, for an individual, only services rendered in California would be subject to withholding. For passthrough entities, only California-source income is subject to withholding.

Example of individual subject to partial withholding

Betsy is a graphic designer who invoiced ABC Inc. $8,000 to design posters for their office. Betsy spent three days in her home state of Florida designing the posters and three days in California planning and installing the posters.

One half of her fee ($4,000) would be subject to withholding.

Example of limited partner withholding

XYZ, Limited Partnership has activities in California, Nevada, and Arizona and has one nonresident partner. XYZ distributed $10,000 in net income to the nonresident partner. Of the $10,000, only $3,000 was California-source income, so XYZ must withhold $210 ($3,000 x 7%) and forward it to California.

$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."

Exceptions to withholding

Individuals

For payments to individuals, withholding is not required if one of the following conditions is met:

- The payment is for goods;
- The payment is being made to a resident of California, or to a corporation or partnership that has a permanent place of business in California. If the resident individual, qualified corporation, or partnership vendor is acting as an agent for the actual vendor, this exception does not apply;
- The total payments of California-source income to the vendor are equal to or less than $1,500 for the calendar year;
- The payments are income from intangible personal property, such as interest and dividends, unless the property has acquired a business situs in California;
- The vendor is an exempt organization under either California or federal law;
- The payments are to a motor carrier providing transportation in two or more states, subject to §11504(b) of Title 49 of the U.S. Code;
- The payments are wages paid to employees;
- The vendor receives a written authorization from the FTB to waive withholding; or
- The vendor is a bank or banking organization.

Passthrough entities

For payments to partners, members, and S corporation shareholders, the following exceptions apply:

- The partner/shareholder is a resident of California;
- The partner is a corporation qualified to do business in California or has a permanent place of business in California;
- The partner is a partnership that has a permanent place of business in California;
- Total distributions of California-source income for the year to the partner or shareholder are $1,500 or less for the calendar year;
- The partner/shareholder receives a withholding waiver from the FTB;
- The partner is a tax-exempt entity either under California or federal law;
- The distribution is of tax-exempt income;
- The distribution is California-source income that was reported on the partner's/shareholder's previous California return;
- The partnership/S corporation does not have any California-source income; or
- The partnership is an investment partnership.

To be an investment partnership, generally 90% of the partnership's assets and gross income must be from qualifying investment securities or bank deposits (interest, dividends, and gains from sales of the securities). A partnership interest in another partnership does not qualify unless it is also an investment partnership.

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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.

File Form 589 online

The FTB no longer accepts Form 589 by fax. The most expeditious manner to file is online. Go to:

www.ftb.ca.gov

The rules are different for domestic nonresident partners and foreign partners. For nonresident domestic partners, the partnership must withhold if it distributes more than $1,500 of California-source distributable income, not return of capital. The withholding rate is 7%. For noncorporate nondomestic foreign partners and members, the withholding rate is the maximum rate 12.3%), and 8.84% for corporate nondomestic foreign partners and members.

Due date of the withholding

Withholding on California source payments to nonresidents must be remitted to the FTB on a quarterly basis, just like estimated tax payments, using Form FTB 592, Resident and Nonresident Withholding Statement. The payments are due at the same time as estimated tax payments for calendar year taxpayers:

Withholding due date	
Payments collected	**Due to FTB**
January 1 – March 31	April 15
April 1 – May 30	June 15
June 1 – August 31	September 15
September 1 – December 31	January 15

Failure to withhold

Under R&TC §18668, withholding agents (businesses) who fail to properly withhold are liable for the amount that should have been withheld. This also includes partnerships. The FTB may collect any withholding from a withholding agent upon notice and demand. So, for dispositions occurring on or after January 1, 2009, collection of withholding by the FTB is not subject to the deficiency assessment provisions.

Passing payment through

Tax deducted and withheld from payments to passthrough entities must be passed through to the entity's partners, members, or shareholders according to their ownership interest in the passthrough entity (unless a special allocation rule applies, in which case, the allocation of withholding follows the special allocation of the income).

Exception

All or a portion of the withholding may be claimed as a credit against the entity's tax due for the taxable year, but only to the extent of the entity's liability. (18 Cal. Code Regs. §18662-7)

No refund of tax deducted and withheld from payments to passthrough entities is allowed. Any credit passed through must be claimed by the partners or shareholders on their own tax returns.

The regulations include a special rule for passthrough entity year-end distributions. Tax withheld from payments made after the close of the taxable year can be applied as payments to the taxable year to the extent those payments represent income required to be included in the return for that taxable year. (Draft Regulation 18 Cal. Code Regs. §19002(c))

Tiered partnerships

If a partnership has invested in another partnership and that partnership withholds, the partnership that withholds must complete Form 592 as if it had withheld that amount so that it can pass the withholding credits on to its partners.

How to determine residency

Two methods are permitted:

- Either have the partner/shareholder complete FTB Form 590; or
- The partnership/S corporation may rely on a California street address as an indication of the residency status. A valid California street address, however, does not include a California post office box, a broker's address, or an "in care of" address.

The term resident includes every individual who is in California for other than a temporary or transitory period. Long or indefinite stays may also constitute residency. For more information, see FTB Publication 1031, Guidelines for Determining Resident Status.

➩ ***See pages Appendix 6 and Appendix 7***

"Nonresident withholding decision chart" and
"State income tax withholding worksheet"

Withholding voluntary compliance program

The FTB's Withholding Voluntary Compliance Program (WVCP) allows eligible withholding agents (businesses and individuals) to remit past-due, nonwage withholding for the previous two calendar years, including interest. If a withholding agent comes forward voluntarily to participate in the program, the FTB will:

- Waive information return penalties for the required look-back period;
- Eliminate withholding audits prior to the look-back period; and
- Limit the tax withholding liability to the two-year look-back period, plus interest.

This program is offered to withholding agents who have a requirement to withhold resident, nonresident, and real-estate withholding and have not previously withheld.

Payee doesn't get credit

The amount paid is not considered withholding and the payees may not claim the withholding on their tax returns (it is considered a penalty, not withholding). However, if the payee provides proof that they reported the income on their California return, the FTB will not assess the penalty equal to withholding liability under R&TC §18668.

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

LLC WITHHOLDING AND MEMBER CONSENT

Every nonresident member of an LLC must sign Form FTB 3832, Limited Liability Company Nonresident Members' Consent. This form provides the FTB with a list of names and TPINs of each nonresident member, along with consent to tax the nonresident members' distributive share of income attributable to California sources. (R&TC §18633.5)

Any nonconsenting nonresident is subject to tax on the LLC's income at the member's highest rate. In this case, a member's tax paid by the LLC is treated as a payment made by the nonresident member, and the LLC treats the tax paid as a distribution for accounting purposes.

Avoiding double withholding

Because nonresident LLC members are subject to withholding on distributions of California-source income in excess of $1,500, as well as withholding if nonresident consent is not provided, the FTB will allow an LLC to reduce a nonconsenting nonresident member's tax by the amount of tax that the LLC previously withheld and paid (7% of California-source distributions) on behalf of the nonconsenting nonresident member. (R&TC §18633.5)

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MORE INFORMATION ON WITHHOLDING

Because the federal and California laws are almost the same, some useful guidance can be found in these publications:

- FTB Publication 1017, Resident and Nonresident Withholding Guidelines;
- IRS Publication 541, Partnerships;
- IRS Publication 519, U.S. Tax Guide for Aliens; and
- IRS Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities.

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:

For the part of the year Dot was a nonresident:	257	÷	365	×	$5,000	=	$3,521
For the part of the 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 taxable whether resident or nonresident:			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

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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 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.

APPENDIX

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 use resident return Nonresident spouse use 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 use resident return Nonresident spouse use 540NR
	Separate	Separate	Resident spouse use resident return Nonresident spouse use 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.

<table>
<tr><th></th><th>TAXPAYER'S DOMICILE</th><th>SPOUSE'S DOMICILE</th><th>Form 540NR,
Married Filing Joint</th><th>Form 540NR,
Married Filing Separately
(taxpayer's)</th><th>Form 540NR,
Married Filing Separately
(spouse's)</th></tr>
<tr><td rowspan="2">1</td><td rowspan="2">Community Property State</td><td rowspan="2">Community Property State</td><td>Schedule CA (540NR),
column A through column D:
all income,
all deductions</td><td>Schedule CA (540NR),
column A through column D:
half of all income,
half of all deductions</td><td>Schedule CA (540NR),
column A through column D:
half of all income,
half of all deductions</td></tr>
<tr><td>Schedule CA (540NR)
column E:
all income taxable
by California</td><td>Schedule CA (540NR)
column E:
half of all income
taxable by California</td><td>Schedule CA (540NR)
column E:
half of all income
taxable by California</td></tr>
<tr><td rowspan="2">2</td><td rowspan="2">Separate Property State</td><td rowspan="2">Separate Property State</td><td>Schedule CA (540NR),
column A through column D:
all income,
all deductions</td><td>Schedule CA (540NR),
column A through column D:
all taxpayer's income,
all taxpayer's deductions</td><td>Schedule CA (540NR),
column A through column D:
all spouse's income,
all spouse's deductions</td></tr>
<tr><td>Schedule CA (540NR)
column E:
all income taxable
by California</td><td>Schedule CA (540NR)
column E:
all taxpayer's income
taxable by California</td><td>Schedule CA (540NR)
column E:
all spouse's income
taxable by California</td></tr>
<tr><td rowspan="2">3</td><td rowspan="2">Community Property State</td><td rowspan="2">Separate Property State</td><td>Schedule CA (540NR),
column A through column D:
all income,
all deductions</td><td>Schedule CA (540NR),
column A through column D:
half of taxpayer's income,
half of taxpayer's deductions</td><td>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</td></tr>
<tr><td>Schedule CA (540NR) column E:
all income taxable
by California</td><td>Schedule CA (540NR)
column E:
half of taxpayer's income
taxable by California</td><td>Schedule CA (540NR)
column E:
all spouse's income taxable
by California plus half
of taxpayer's income
taxable by California</td></tr>
<tr><td rowspan="2">4</td><td rowspan="2">Separate Property State</td><td rowspan="2">Community Property State</td><td>Schedule CA (540NR),
column A through column D:
all income,
all deductions</td><td>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</td><td>Schedule CA (540NR),
column A through column D:
half of spouse's income,
half of spouse's deductions</td></tr>
<tr><td>Schedule CA (540NR)
column E:
all income taxable
by California</td><td>Schedule CA (540NR)
column E:
all taxpayer's income plus
half of spouse's income
taxable by California</td><td>Schedule CA (540NR)
column E:
half of spouse's income
taxable by California</td></tr>
</table>

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

Note

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

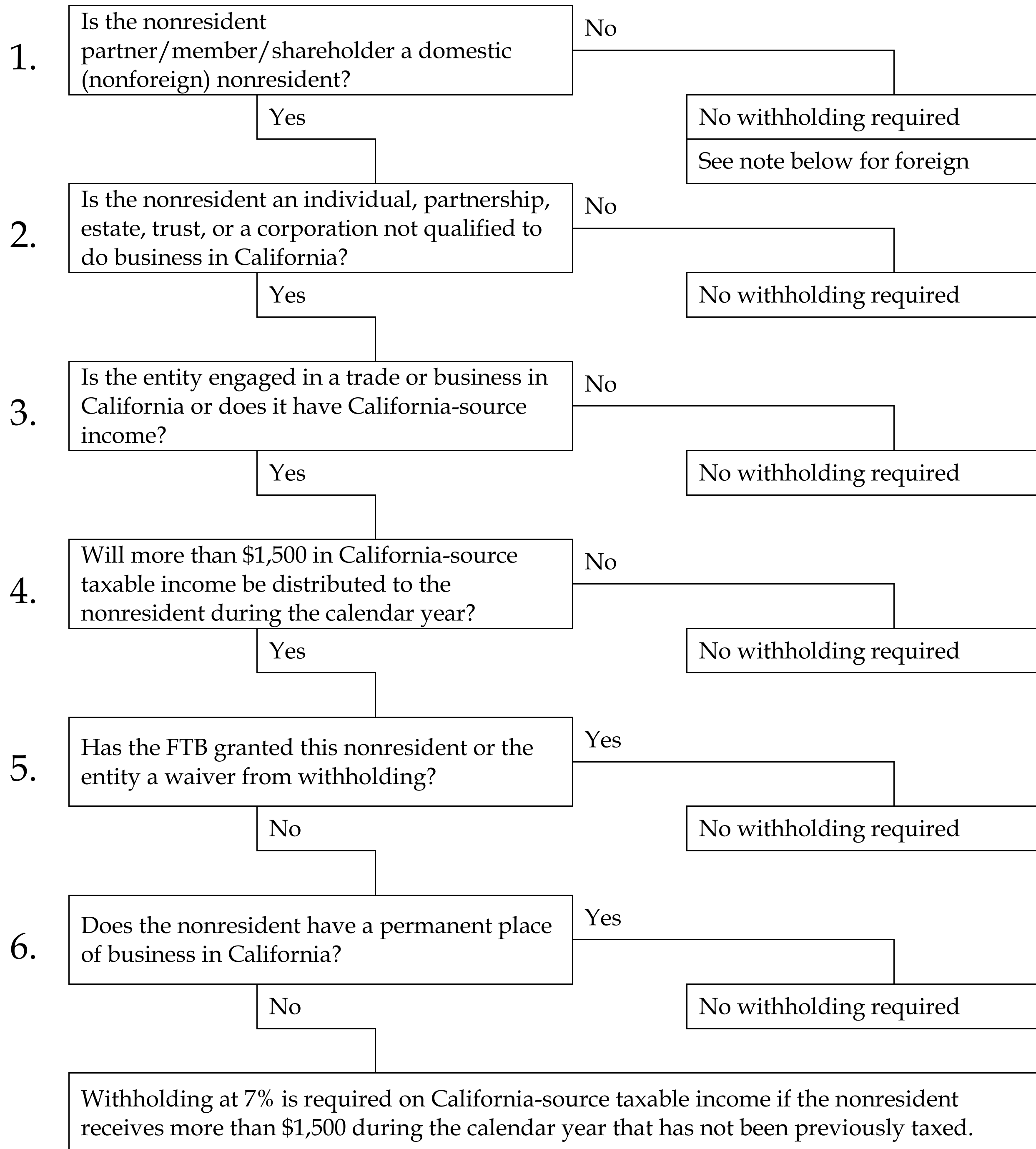
	Domestic nonresidents	Nonresident: S corporation shareholders Domestic partners or members Beneficiaries	Foreign nonresidents (except partners and members)	Foreign partners and members
Rate of withholding	7%	7%	7%	Non-corporate: 9.3% Corporate: 8.84% Foreign banks: 10.84%
Withholding base	California-source payments in excess of $1,500 in one year Property managers may subtract the property manager's fee from withholding base	Distributions of current- or prior-year income of more than $1,500 to any one shareholder, partner/ member or beneficiary during the year	California-source income in excess of $1,500 in one year	Allocations of California-source income with no minimum amount (exception for certain effectively connected income)
Date to remit withholding	Quarterly: April 15, June 15, September 15, January 15	Quarterly: April 15, June 15, September 15, January 15	Quarterly: April 15, June 15, September 15, 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, Quarterly Resident and Nonresident Withholding Statement	592, Quarterly Resident and Nonresident Withholding Statement	592, Quarterly Resident and Nonresident Withholding Statement	592-A, Foreign Partner or Member Quarterly Withholding Remittance Statement
Annual report to the FTB	None	None	None	592-F, Foreign Partner or Member Annual Return, by 15th day of 4th month following close of tax year
Annual report to recipient	592-B, Resident and Nonresident Withholding Tax Statement, by January 31 following close of calendar year	592-B, Resident and Nonresident Withholding Tax Statement, by January 31 following close of calendar year	592-B, Resident and Nonresident Withholding Tax Statement, by January 31 following close of calendar year	592-B, Resident and Nonresident Withholding Tax Statement, by 15th day of 4th month following close of tax year
Exemption certificate	590, Withholding Exemption Certificate	590, Withholding Exemption Certificate	590, Withholding Exemption Certificate	N/A
Waiver request	588, Nonresident Withholding 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	FTB Form 589 Nonresident Reduced Withholding Request

NONRESIDENT WITHHOLDING PROCESS

Phase	Forms to use	Phase tasks
Before withholding agent makes payment to nonresident payee	FTB Form 590, Withholding Exemption Certificate	Payee who is a California resident or a business with resident status can use Form 590 to certify exemption from nonresident withholding. No withholding required with a valid withholding exemption certificate. Withholding agent keeps a copy of Form 590 in records.
	FTB Form 588, Nonresident Withholding Waiver Request	Nonresident payee who qualifies can use Form 588 to 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. Withholding agent keeps a copy of the waiver certificate in records. No withholding required with a waiver certificate.
	FTB Form 589, Nonresident Reduced Withholding Request	Nonresident payee can use Form 589 to itemize expenses against the California source income. Form 589 must be submitted at least 21 business days before payment is made. FTB provides withholding agent a letter stating the reduced withholding amount.
At the time withholding agent makes payment to nonresident payee	There are no FTB forms to use, but withholding agents will develop their own internal processes for withholding.	Withholding agent withholds 7% of all California source payments to a nonresident payee that exceed $1,500 in a calendar year, unless payee qualifies for reduced or waived withholding.
After withholding agent makes payment to nonresident payee	FTB Form 592, Resident and Nonresident Withholding Statement	After making a payment to a nonresident payee, withholding agent sends FTB a timely Form 592, either electronically or by mail. The 592 contains a list of all payees withheld upon during the filing period. FTB posts the withholding to the payees' accounts.
	FTB Form 592-V, Payment Voucher for Resident and Nonresident Withholding	Withholding agent remits Form 592-V with payment when submitting a completed Form 592 to FTB.
	FTB Form 592-B, Resident and Nonresident Withholding Tax Statement	By January 31 following the end of the calendar year, withholding agent sends each payee a completed 592-B and keeps a copy for records. A payee claims the withholding by attaching a copy of the 592-B when filing the required California tax return. The 592-B is proof of California source income and withholding credit.

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)

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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: Non-taxable 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.

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 in:	______	______	______	______
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?	______	______	______	______

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	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 nonresident?	☐ 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.

   Note

   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))

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CALIFORNIA INCOME:
TAXABLE OR NOT TAXABLE TO A NONRESIDENT

Type of income	
Income from business activities in California	See note below
Income from business activities outside California by a California business	See note below
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[1]
Payment for services performed in California	Taxable
Payment for services performed outside California for a California business, trade, or profession	Not taxable
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[2]	Taxable
Income from California S corporation	Taxable
Gain on sale of partnership interest	Not taxable[3]
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

Note: Income from personal services is taxable if the client is located in California. See R&TC §§25128 and 25136 for information on apportionment and single sales factor

[1] 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 (18 Cal. Code Regs. §17952)

[2] 18 Cal. Code Regs. §17952

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

INCOME REPORTING REQUIREMENTS FOR MILITARY SERVICEMEMBERS AND CIVILIAN SPOUSES

<table>
<tr><th colspan="2">Income reporting requirements
(when qualified under the MSRRA and residing in California)</th></tr>
<tr><td colspan="2">M = Military Servicemember; S = Spouse</td></tr>
<tr><td>M – Domiciled in a community state (other than California) and stationed in California all year

S – Domiciled in same community property state as M and resided in California all year</td><td>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).

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).</td></tr>
<tr><td>M – Domiciled in a separate property state and stationed in California all year

S – Domiciled in the same separate property state as M resided in California all year</td><td>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).

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.

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).</td></tr>
</table>

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)

Note

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

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 merchant seaman was taxable as a resident for 1968, although he spent 210 days at sea. He owned a home jointly with his wife and maintained bank accounts in California. He had no ties with any other state and thus was domiciled in California and not a resident of any other state or country. (***Appeal of Bernard and Helen Fernandez*** (June 2, 1971) 71-SBE-016)

A merchant seaman who owned a residence and a condominium in California, registered his automobile in California, had a California driver's license, had checking and savings accounts in California, registered to vote in California, belonged to a union local in San Francisco, used a California doctor and a lawyer, and whose wife, with whom he spent all of his time while not at sea, lived in Napa, was a California resident for tax purposes. (***Appeal of Alfred L. and Jean M. Steinman*** (April 5, 1983) 83-SBE-095)

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)

A taxpayer was a resident of California for taxation purposes as his absences from California were for temporary or transitory purposes based on facts that indicated that his closest contacts were with California and indicated that he received sufficient benefits and protection from the laws and government of the state to warrant his classification as a resident. (***Appeal of Duane H. Laude*** (October 6, 1976) 76-SBE-096)

EXAMPLES OF SEAMEN WHO WERE NOT RESIDENTS

Note

In all 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 SERVICE PERSONNEL

A resident who left California to pursue a military career, returning only for short visits to see his parents over a period of many years, was not a resident. If the wife remains a California resident, she is taxable on one-half of her husband's community income provided the husband retains his California domicile. (***Appeal of Harold L. and Miriam Jane Naylor*** (December 11, 1963) 63-SBE-143)

A California reserve officer in the Air National Guard was only absent from California for a temporary or transitory purpose when he was placed on active duty to attend out-of-state service schools for eight months. (***Appeal of Cecil L. and Bonai G. Sanders*** (June 2, 1971) 71-SBE-018)

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)

Taxpayers who moved from California to Texas and tried to establish a Texas domicile did not cut their ties with California and were found to be California residents. (***Appeal of James and Jean A. Bagley*** (2004) Cal. St. Bd. of Equal., No. 217274) The Board compiled a list of residency indicators, including number of days spent in each state by each spouse, locations of dwellings, number of vehicles maintained in each state, locations of doctors and lawyers, locations of social memberships, etc. The indicators were fairly evenly divided between California and Texas.

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)

Although physically present in California for short periods, the taxpayer had close connections with California that showed that absences were temporary or transitory. (***Appeal of John Haring*** (August 19, 1975) 75-SBE-053)

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.)

The taxpayer was out of California for temporary or transitory purposes and therefore retained his California residency during his absence when he spent five months in Australia to determine whether he wished to work there later for a more extended period. (***Appeal of Malcolm A. Coffman*** (October 6, 1976) 76-SBE-086)

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 husband, a professor at a California university, was absent with his family from the state for approximately one academic year, and although he returned to the same California position that he had held for many years, it was found that because he contracted for foreign employment on a year-to-year basis while in Europe and had severed many, but not all, California connections, he was therefore a California nonresident. (***Appeal of David A. and Frances W. Stevenson*** (March 2, 1977) 77-SBE-046)

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)

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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 their presence in the state was for other than temporary or transitory purposes due to employment, principal place of abode, bank accounts, automobile registrations, and drivers' licenses in California — thus indicating, in comparison to contacts elsewhere, that they had their closest connections with California. (***Appeal of George M. and Georgia M. Webster*** (May 10, 1977) 77-SBE-083)

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)

The Nobles argued that by March 1, 1994, they intended to move to Colorado and the "transition" of their move to Colorado had "progressed far enough" that their California residency had ended, and their presence in California had become for a "temporary or transitory purpose." However, the court noted that physical presence in the state has been "a factor of greater significance than the mental intent or outward formalities of ties to another state," and the Nobles lost their argument.

NATIVE AMERICANS WITH TRIBAL-SOURCE INCOME

A Native American may have a home off tribal land and be exempt from tax on income from tribal sources if he or she lives on the tribal land. (***Appeal of Robert J. Murphy*** (2005) Cal. St. Bd. of Equal., Case No. 255127) The taxpayer owned a home inside the reservation, but he maintained a homeowner's property tax exemption on a home in Corona (outside the reservation). The FTB pointed out that the property tax exemption is granted on an owner-occupied house, and therefore the taxpayer did not live inside the reservation, making him a California resident.

The taxpayer argued that he was unaware of the property tax exemption claimed on the Corona property. He provided utility bills, insurance documents, vehicle registration documents, and a letter from the Tribal Chief supporting his contention that he resided on the reservation. He also provided evidence that his niece lived in the Corona property. Based on this evidence, the Board found that the taxpayer did reside on the reservation, and that his reservation-source income was not taxable to California.

> ***Note***
>
> The taxpayer in this case prevailed because he was able to present evidence to support his position. In ***Appeal of Jason Barajas*** ((December 15, 2004) Cal. St. Bd. of Equal., Case No. 252223), the taxpayer was unable to present evidence supporting his position and was taxed on reservation-source income.

Factors the Board considers

The Board did not have the jurisdiction to hear the appeal of a taxpayer whose per capita gaming distributions were subject to California tax because his appeal was not timely filed with the Board. (***Appeal of Gregory B. Duro*** (February 28, 2008) Cal. St. Bd. of Equal., Case No. 354992) However, his case is an excellent illustration of the factors the FTB looks at to determine where an individual is living.

In ***Duro***, the taxpayer alleged that he lived on the reservation with his parents, although he owned a home off of the reservation. He used his parents' address on his tax returns, for his driver's license, vehicle registration, utility bills, and financial and insurance statements. He also listed his parent's address as his address of record with his tribe.

He alleged that the home off of the reservation was purchased for his grandmother, and that he only stayed with her occasionally.

The FTB countered this allegation stating that all of the following factors supported the fact that he was no longer living with his parents, but was actually living in the home he owned off of the reservation:

- His grandmother owned another home of her own during the year in question;
- In a protest letter, the taxpayer stated that his grandmother began living in the home after the year in question;
- The taxpayer claimed a homeowner's property tax exemption for the home; and
- It seemed that a four-bedroom, 3.5 bath residence with a pool and a spa was more home than a single 75-year-old woman (who owned another home) would require.

'Second home'

Per capita gaming distributions received by a Native American while he was incarcerated off the reservation were subject to California income tax, according to the Board. (***Appeal of Victor E. Andrade, Jr.*** (February 28, 2008) Cal. St. Bd. of Equal., Case No. 382910)

In ***Andrade***, the taxpayer alleged that his per capita gaming distribution of $523,333 should be exempt from California tax because:

- Although he was in prison off of the reservation, a prison is a place of involuntary confinement and not a place of permanent residence; and
- The R&TC violates his right to equal protection because he was unable to live on his tribe's reservation because there is not sufficient housing for tribal members.

The FTB argued that the fact that the taxpayer was incarcerated was irrelevant. They pointed to the taxpayer's contradictory arguments that he lived on the reservation and that his equal rights were violated because he was unable to live on the reservation.

Because the taxpayer was not able to demonstrate that he lived on the reservation prior to his incarceration, all of his income was subject to California tax.

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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)

The compensation of employees of a foreign country shall be determined in accordance with IRC §893.

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)