

# ANALYSIS OF ORIGINAL BILL

Author: Hertzberg Analyst: Diane Deatherage Bill Number: SB 500  
 Related Bills: None Telephone: 845-4783 Introduced Date: February 26, 2015  
 Attorney: Bruce Langston Sponsor \_\_\_\_\_

<b>SUBJECT:</b>	Nonresident Employee/Exclude Short Periods of Work in California from California Source Income
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## SUMMARY

This bill would establish a "de minimis" exception to the general rule under the Personal Income Tax Law (PITL) regarding the taxability of California source income of nonresidents and the withholding of payroll taxes from that income.

This analysis will not address the bill's changes to the Unemployment Insurance Code, as they do not impact the department or state income tax revenue.

This analysis only addresses the provisions of the bill that impact the department's programs and operations.

## RECOMMENDATION

No position.

## REASON FOR THE BILL

The reason for this bill is to reduce the burden the state places on traveling nonresident employees and their employers; thereby attracting out-of-state business. This bill simplifies nonresident employee and employer requirements to report and withhold state income taxes.

## EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2016, and specifically operative for compensation received on or after January 1, 2016.

## PROGRAM BACKGROUND

Employees performing employment duties out of their state of residency may be subject to income tax and withholding in the state in which they are performing their employment duties.

The difficulties inherent in subjecting nonresident employees to income tax and nonresident employers to withholding rules, and in balancing any legislative or regulatory approach with concerns regarding potential double taxation of income by the employer's and/or employee's

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state of residency, have become the subject of national debate. A number of states have no stated income threshold for purposes of the filing requirement they impose on nonresidents.<sup>1</sup> However, a number of states have stated income thresholds for services performed in the state before requiring nonresidents to file there.<sup>2</sup> In addition, wage withholding requirements pose challenges for employers when employees earn wage income during visits to multiple states as the requirements may be different for each state.

Although not a federal law problem per se, because all wages are subject to federal income tax regardless of the state in which they are earned, these issues have received widespread national attention. The Federal Mobile Workforce State Income Tax Simplification Act (Federal Act) of 2015 ([S. 386](#)) is currently pending in Congress and would:

- Limit states from imposing tax and requiring wage withholding on income of employees performing duties in more than one state to (1) the state of the employee's residence and (2) those states where the employee is present and performing employment duties for more than 30 days during the calendar year.
- Specify the state of attribution for work days that are split between the employee's home state and another state or for work days that are spent in transit.
- Exclude professional athletes, entertainers, and certain public figures that perform services for compensation on a per-event basis from the Federal Act's definition of "employee."

Opposition from the states and the Federation of Tax Administrators is based on the perception of federal preemption in matters of state taxation. The chance for enactment of the Federal Act is unknown.

The Multistate Tax Commission (MTC) Model Mobile Workforce Statute, adopted July 27, 2011, is similar in concept to the Federal Act but attempts to address elements of the Federal Act that are objectionable or problematic to some. It provides for a 20-day threshold for employees instead of 30 days. In addition, by its terms, the model statute only applies to those nonresidents whose state of residence provides a substantially similar exclusion or does not impose an individual income tax. The MTC Model Mobile Workforce Statute exempts the following from the definition of "employee:"

- A professional athlete or member of a professional athletic team;
- A professional entertainer who performs services in the professional performing arts;

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<sup>1</sup> Arkansas, Delaware, Indiana, Kansas, Kentucky, Louisiana, Nebraska, New Mexico, North Dakota, Ohio, Rhode Island, and Utah.

<sup>2</sup> Georgia (the lesser of \$5,000 or 5 percent of the income received from performing services in all places), Idaho (more than \$2,500), Iowa (\$1,000 or more and net income from all sources exceeds specified levels), Massachusetts (the lesser of \$8,000 or the prorated personal exemption), Minnesota (\$10,000), Missouri (\$600), Oklahoma (\$1,000), Pennsylvania (\$33), Vermont (\$100), and Wisconsin (\$2,000).

- A person of prominence who performs services for compensation on a per-event basis;
- A person who performs construction services to improve real property, predominantly on construction sites, as a laborer;
- A key employee, without regard to ownership or the existence of a benefit plan, for the year immediately preceding the current tax year; and
- An employee of a non-corporate employer who would be a key employee, without regard to ownership or the existence of a benefit plan, for the year immediately preceding the current tax year if the term "employee" were substituted for the term "officer" in Internal Revenue Code section 416(i)(1)(A)(i) and if the person is one of the non-corporate employer's 50 highest-paid employees without regard to whether the person is an officer.

## **FEDERAL/STATE LAW**

Federal law contains rules for the taxation of persons who are not citizens of the United States (aliens) that have income from sources within the United States. Those rules relating to aliens (whether resident or nonresident) are specifically inapplicable under California law.

### ***Nonresident Income Sourcing, Exclusion***

Existing state law imposes tax on the income earned by individuals, estates, trusts, and certain business entities. California residents are taxed on all income, including income from sources outside California. This includes all wages and salaries earned while a California resident, regardless of where the services were performed. Part-year residents of California are taxed on all income received while a resident, including income from sources outside California and regardless of where the services resulting in the income were performed, and only on income from California sources while a nonresident.<sup>3</sup> In general, nonresidents of California are subject to California income tax on all income from California sources.<sup>4</sup> The tax for individuals is computed on a graduated scale at rates ranging from 1 percent to 13.3 percent.

Income from sources within California includes income from all of the following:

- Real or tangible personal property located in California;<sup>5</sup>
- A business, trade, or profession carried on in California;<sup>6</sup>
- Income from stocks, bonds, notes, bank deposits and other intangible personal property having a business or taxable situs in California;<sup>7</sup>

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<sup>3</sup> R&TC section 17041.

<sup>4</sup> R&TC sections 17041 and 17951. Limited exceptions apply for merchant seamen, air carrier, rail carrier, and motor carrier employees, as well as military service members.

<sup>5</sup> Cal. Regs. sections 17951-2 and 17951-3.

<sup>6</sup> Cal. Regs. sections 17951-2 and 17951-4.

<sup>7</sup> Cal. Regs. sections 17951-2, 17952.

- Rentals or royalties for the use of, or for the privilege of using in California, patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property having a taxable or business situs in California;<sup>8</sup> and
- Total compensation for periods employees are employed in California or perform personal services in California.<sup>9</sup>

California source qualified retirement income received by a nonresident is specifically excluded from California gross income.<sup>10</sup> Different sourcing rules based on a formula comparing the number of working days in California to the number of working days elsewhere are applied for purposes of determining the proper percentage of deferred compensation subject to California income tax, whether by stock option, restricted stock units, or other similar vehicle, earned by nonresidents who performed some services in California during the applicable vesting period.

Special sourcing rules apply to:

- Commissions earned by nonresident traveling salespeople, agents, or other employees for services performed or sales made, the compensation for which depends directly on the volume of business transacted;
- Gross amounts received for performances in California by nonresident actors, singers, performers, entertainers, and athletes;
- Fees or compensation for services performed in California on behalf of their clients by nonresident attorneys, physicians, accountants, engineers, etc., even when they are not regularly engaged in carrying on their professions in California;
- The total compensation for the period employed in California of nonresident employees including officers of corporations, but excluding employees who are salespeople, agents, or others whose compensation depends directly on the volume of business transacted, who are employed continuously in California for a definite portion of any taxable year; and
- Compensation of nonresident employees such as operators of trains, boats, aircraft, motor buses, trucks, etc., who are employed in California at intervals throughout the year and are paid on a daily, weekly, or monthly basis.<sup>11</sup>

If nonresident employees (including officers of corporations, but excluding employees that are receiving commission) are employed continuously in this state for a definite portion of any taxable year, the gross income of the employees from sources within this state includes the total compensation for the period employed in this state.<sup>12</sup>

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<sup>8</sup> Cal. Regs. sections 17951-2, 17952.

<sup>9</sup> Cal. Regs. sections 17951-2, 17951-5.

<sup>10</sup> R&TC section 17952.5, Cal. Regs. section 17951-2.

<sup>11</sup> Cal. Regs. section 17951-5.

<sup>12</sup> Cal. Regs. section 17951-5.

If nonresident employees are employed in this state at intervals throughout the year, between this state and other states and foreign countries, and are paid on a daily, weekly or monthly basis, the gross income from sources within this state includes that portion of the total compensation for personal services which the total number of working days employed within this state bears to the total number of working days both within and without the state.

Nonresidents must file a return if they have any California source income and their income from all sources meets or exceeds the filing requirement amounts for residents. Current law contains no "de minimis" exception to the general rule regarding the taxability of California source income of nonresidents.<sup>13</sup>

### ***Nonresident Withholding, Exclusion***

Employers generally must withhold payroll income tax from employees' wages. California's payroll taxes are administered by the Employment Development Department (EDD).

When an employee performs services in California as well as in one or more other states, the state(s) that has jurisdiction for coverage of that employee's services is determined by the application of four tests: (1) localization; (2) base of operations; (3) place of direction and control; and (4) residence of employee. These tests are used by all states to determine where the employee's services are subject to employment taxes. An employee must perform some service in California before the tests can be applied to determine whether all or a portion of the employee's services can be allocated to California.

The wages paid to a nonresident employee while performing services within California are subject to California personal income tax withholding. The amount of wages subject to California personal income tax withholding is that portion of the total number of working days employed in California compared to the total number of working days employed in both California and the other state.

### **THIS BILL**

This bill would modify the Revenue and Taxation Code regarding taxation of nonresident employee compensation that would be similar to the MTC Model Mobile Workforce Statute; specifically, the bill would accomplish the following:

- Exclude from California source income "de minimis income" received on or after January 1, 2016, for any part of the taxable year during which the taxpayer was not a resident of California.

"De minimis income" would mean compensation subject to withholding under the Unemployment Insurance Code that is received by a nonresident if the following apply:

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<sup>13</sup> Revenue and Taxation Code (R&TC) section 17041.

- The nonresident employee has no other income sourced to California,
- The nonresident is present in the state no more than 20 days (including part of any day) during the taxable year performing employment duties on behalf of an employer and any other related person, and
- The nonresident's state of residence provides a substantially similar exclusion or does not impose a personal income tax.

“Related person” would mean a person that, with respect to the employer during all or any portion of the taxable year, is one of the following:

- A related entity,
- A member of a commonly controlled group,
- A person to or from whom there is attribution of stock ownership, or
- A person that notwithstanding its form of organization bears the same relationship to the employer as the previous examples of a “related person.”

This bill would not apply to compensation received by any of the following:

- An individual who is a professional athlete or member of a professional athletic team.
- An individual who is a professional entertainer who performs services in the professional performing arts.
- An individual of prominence who performs services for compensation on a per-event basis.
- An individual who is identified as a key employee, within the meaning of Section 416(i)(1)(A)(i) of the Internal Revenue Code<sup>14</sup>, for the taxable year immediately preceding the current taxable year.

In addition, this bill would provide the following:

- An exception from filing a state tax return if a nonresident's only income from sources in this state is compensation and if the requirements of this bill are met.
- Upon request of the Franchise Tax Board, a nonresident may be required to file an informational return.
- This bill is applicable to the determination of an individual income taxpayer's filing requirement and has no application to the imposition of, or jurisdiction to impose a tax under the PITL or any other tax on any taxpayer.
- Nothing in this bill is intended to have any bearing on the sourcing rules for determining the taxability by this state of deferred compensation earned by performing services in this state during any portion of the applicable vesting period, whether by stock option, restricted stock units, or any other means, based on a formula comparing the number of working days in this state to the number of working days elsewhere, and no de minimis period applies to those determinations.

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<sup>14</sup> In general, the term “key employee” means an employee who, at any time during the plan year, is an officer of the employer having an annual compensation greater than \$130,000.

## IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

## OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

*Florida* does not impose an individual income tax. The other five states do not have a de minimis exception to the general rule regarding the taxability of source income of nonresidents.

*Illinois, Michigan, Massachusetts, Michigan, and Minnesota* do not have a de minimis exception for employers' withholding.

*New York* has a de minimis rule of 14 days where an employer is not required to withhold tax on wages paid to a nonresident if the employee works 14 days or less in the state. *New York* has no de minimis exception for taxability of wages received by nonresident employees.

## FISCAL IMPACT

This bill would not significantly impact the department's costs.

## ECONOMIC IMPACT

### Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB 500 As Introduced February 26, 2015 Assumed Enactment After June 30, 2015		
2016-17	2017-18	2018-19
- \$200,000	- \$200,000	- \$200,000

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

### Revenue Discussion:

The expected loss from excluding compensation for employment (wages) from income for nonresident taxpayers who work in California for 20 days or less and have no other California source income is approximately \$200,000 per year. Using nonresident personal income tax data for tax year 2012, it was determined that approximately \$3 billion in wages were paid to residents of states that would meet the exclusion provisions defined in this bill. This number drops to approximately \$4 million when nonresidents who have other California-sourced income are

removed. Applying an average tax rate of 5 percent results in the estimated loss of \$200,000 per year. This tax year impact was grown, rounded, and converted to the fiscal year estimates reflected in the table above.

## **SUPPORT/OPPOSITION**

Support: None provided.

Opposition: None provided.

## **ARGUMENTS**

Proponents: Some may argue that certain nonresident employee's and employer's reporting requirements will be simplified making short-term assignments within California more attractive for employers and their nonresident employees.

Opponents: Some may argue that a 20-day period exceeds what would be considered “de minimis” and unfairly shifts the burden of paying for public services from nonresident employees that benefit from them.

## **LEGISLATIVE STAFF CONTACT**

Diane Deatherage  
Legislative Analyst, FTB  
(916) 845-4783  
[diane.deatherage@ftb.ca.gov](mailto:diane.deatherage@ftb.ca.gov)

Jame Eiserman  
Revenue Manager, FTB  
(916) 845-7484  
[jame.eiserman@ftb.ca.gov](mailto:jame.eiserman@ftb.ca.gov)

Gail Hall  
Legislative Director, FTB  
(916) 845-6333  
[gail.hall@ftb.ca.gov](mailto:gail.hall@ftb.ca.gov)