# 3000 SOURCE OF INCOME LAWS, TERMS, AND CONCEPTS

# 3100 CALIFORNIA TAXATION

## Residents

California taxes residents of California on their entire taxable income in accordance with R&TC Section 17041(a) and (c).

**Example 1**

Mary, a California resident, has the following income:

| | |
|---|---|
| Wages earned in California | $45,000 |
| Wages earned in Japan | $30,000 |
| Interest from Nevada bank account | $10,000 |
| Total | $85,000 |

**Determination:**

Because Mary is a California resident, her total income of $85,000 is taxable by California.

## Nonresidents

R&TC Section 17951 provides that gross income of nonresidents includes only income from California sources. The word "source" pertains to the place of origin.

R&TC Section 17041(b) and (d) provide that nonresidents are taxed only on taxable income derived from sources within California.

**Example 2**

John, a nonresident of California, has the following income:

| | |
|---|---|
| Wages earned in California | $45,000 |
| Wages earned in Japan | $30,000 |
| Interest from Nevada bank account | $10,000 |
| Total | $85,000 |

**Determination**

Because John is a nonresident, only his California source wages of $45,000 are taxable by California.

## Part-Year Residents

R&TC Section 17015.5 defines the term "part-year resident" to mean a taxpayer who meets both of the following conditions during the same taxable year:

A. Is a resident of this state during a portion of the taxable year.

B. Is a nonresident of this state during a portion of the taxable year.

California taxes part-year residents on taxable income derived from California sources during the period they were nonresidents under R&TC Section 17041(b) and (d) and their entire taxable income during the period in which they were residents under R&TC Section 17041(a) and (c).

**Example 3**

Beth became a California resident on July 1, 2001. She earned the following income during 2001:

| | |
|---|---|
| Florida wages from January 1, 2001, to June 30, 2001 | $50,000 |
| California wages from January 1, 2001, to June 30, 2001 | $10,000 |
| California wages from July 1, 2001, to December 31, 2001 | $30,000 |
| Florida wages from July 1, 2001, to December 31, 2001 | $ 5,000 |
| Total | $95,000 |

**Determination:**

California taxes the following income:

| | |
|---|---|
| California wages from January 1, 2001, to June 30, 2001 | $10,000 |
| California wages from July 1, 2001, to December 31, 2001 | $30,000 |
| Florida wages from July 1, 2001, to December 31, 2001 | $ 5,000 |
| Total | $45,000 |

R&TC Section 17041(b) and (d) provide that nonresidents and part-year residents compute their tax liability by multiplying their taxable income (defined below) by a rate equal to the amount of tax they would owe if they were residents of California for the taxable year and for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by the amount of that income.

The term "taxable income of a nonresident or part-year resident" as defined in R&TC Section 17041(i)(1) includes each of the following:

(A) For any part of the taxable year during which the taxpayer was a California resident, all items of gross income, and all deductions, regardless of source.

(B) For any part of the taxable year during which the taxpayer was not, a resident of California, gross income and deductions derived from sources within California.

For taxable years beginning in 2002, nonresidents and part-year residents determine their California tax by multiplying their California taxable income by an effective tax rate. The effective tax rate is the California tax on all income as if the taxpayer were a California resident for the current tax year and for all prior tax years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by that income.

Use the following formula:

$$\text{Prorated tax} = \text{California taxable income} \times \frac{\text{Tax on total taxable income}}{\text{Total taxable income}}$$

**Key Definitions**

| | |
|---|---|
| California taxable income: | California adjusted gross income (AGI) less California itemized or standard deductions. |
| California AGI: | Gross income and deductions derived from California sources for any part of the taxable year during which a taxpayer was a nonresident **plus** all items of gross income and all deductions, regardless of source, for any part of the taxable year during which the taxpayer was a resident. |
| Total AGI: | The adjusted gross income from all sources for the entire taxable year. |
| California itemized or standard deductions: | Determined by applying the ratio of California AGI to total AGI to **all** itemized or standard deductions allowed to California residents. |
| Total taxable income: | The entire taxable income determined as if the taxpayer were a California resident for the current taxable year, **and** for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions. |

**Percentage Calculations**

Itemized or standard deductions: Divide the California AGI by the total AGI (not to exceed 1.0):

$$\frac{\text{California AGI}}{\text{Total AGI}}$$

Tax rate: Divide the tax on total taxable income by the total taxable income:

$$\frac{\text{Tax on total taxable income}}{\text{Total taxable income}}$$

Credits: Divide the California taxable income by the total taxable income:

$$\frac{\text{California taxable income}}{\text{Total taxable income}}$$

**Note:** This percentage does not apply to renter's credit, other state tax credit, or credits conditional upon a transaction occurring wholly within California. California allows these credits in full.

The following example shows how the calculation works:

**Example 4 Taxable Year 2002:**

John was a Florida resident until March 31, 2002. While a Florida resident, he earned and received wage income of $15,000 and interest income of $1,000. On April 1, 2002, John permanently moved to California. While a California resident, John earned and received wage income of $65,000 and interest income of $3,000. John was single and had the following itemized deductions in 2002:

| | | |
|---|---|---|
| Real estate taxes | $ 1,200 | (California house) |
| | 800 | (Florida house) |
| Mortgage interest | 17,000 | (California house) |
| | 3,500 | (Florida house) |
| Charitable contributions | 1,500 | (New York Firefighters' Fund) |
| | $ 24,000 | |

**Calculation of John's 2002 California tax liability:**

| | | |
|---|---|---|
| California AGI | $65,000 | (California 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) |
| | x .8095 | (California AGI ÷ Total AGI) |
| | $19,428 | |
| CA taxable income | $68,000 | (California AGI) |
| | -19,428 | (California itemized deductions) |
| | $48,572 | |
| Total taxable income | $84,000 | (Total AGI) |
| | -24,000 | (Total itemized deductions) |
| | $60,000 | |
| Tax on total taxable income | $ 3,705 | (Tax table) |
| Prorated tax | $48,572 | (California taxable income) |
| | x .0618 | Tax on total taxable income / Total taxable income |
| | $ 3,002 | |

| | | |
|---|---|---|
| Prorated exemption credit | $80 | (Personal exemption credit) |
| | x .8095 | California taxable income / Total taxable income |
| | $65 | |
| Tax liability | $ 3,002 | (Prorated tax) |
| | - 65 | (Prorated exemption credit) |
| | $ 2,937 | |

## 3200 COMMUNITY INCOME

CCR Regulations Section 18501 requires that if a married couple files separate returns, each spouse must report all income from his or her separate property and one-half of any community income. We divide community income equally between spouses. According to the regulation, the laws of the state where the earning spouse is domiciled determine whether or not income is considered community income. If the acquiring spouse is domiciled in a community property state, we consider his or her income community income. If the acquiring spouse is domiciled in a separate property state, we consider his or her income separate income.

The Appeal of Richard and Eva Taylor, 1988-SBE-028, November 29, 1988, considers the allocation of income where the husband leaves this state but remains domiciled in California while absent for other than a temporary and transitory purpose. Publication 1031, *Guidelines for Determining Resident Status*, contains a chart illustrating how spouses filing separate returns should split their income.

**Example 1**

Mark and Lisa are married. Mark is domiciled in and a resident of California. Lisa is domiciled in California, but a resident of Michigan. Mark sometimes travels outside of California to perform his work. For 2001, Mark earned $70,000 while working in California and $30,000 while working in Iowa. He had no other income for 2001. Lisa earned no income during 2001.

**Determination:**

**Step 1**

**Split income based on domicile.**

Mark is domiciled in California, a community property state. Therefore, Mark's wage income must be split 50/50 with his spouse Lisa.

| Wages | Mark | Lisa |
|---|---|---|
| California, $70,000 | $35,000 | $35,000 |
| Iowa, $30,000 | $15,000 | $15,000 |
| Total: | $50,000 | $50,000 |

**Step 2**

**Apply California source of income law.**

Mark is a California resident. Residents are taxed on income from **all** sources. Lisa is a nonresident of California. Nonresidents are taxed on income from **California** sources.

| Income | taxable by California |
|---|---|
| Mark's 50 percent share of his wages: | $50,000 |
| Lisa's 50 percent share of Mark's wages earned in California: | $35,000 |
| Total | $85,000 |

If a husband and wife are separated with no intention of resuming a marital relationship and choose to file separate returns, they must report all income separately.

The following states are community property states:

| | | |
|---|---|---|
| Arizona | Louisiana | Texas |
| California | Nevada | Washington |
| Idaho | New Mexico | Wisconsin |

According to IRS Pub 555, *Community Property*, income from most separate property is community income in Idaho, Louisiana, Texas, and Wisconsin. In the other community property states, income from separate property is not community income.

## 3300 REAL OR TANGIBLE PERSONAL PROPERTY

According to CCR Regulations Section 17951-3, income derived from real or tangible personal property located in this state is California source income. This includes:

- Rents from real and tangible personal property located in California.
- Gains realized from the sale or transfer of such property regardless of where the sale or transfer is consummated.
- Any other type of income derived from the ownership, control, or management of real and tangible personal property located in California irrespective of whether a trade, business, or profession is carried on within California.

**Example 1**

Brian, a nonresident of California, owns a rental home located in California. His net income from the rental property is $7,000.

**Determination:**

The $7,000 is taxable by California because the source of the rental income is California.

The Appeal of L. N. and Mary C. Hagood, 1960-SBE-026, November 14, 1960, held that oil and gas leases of lands located in California constitute real property and the income derived from the leases was California source income.

## 3310 BUSINESS, TRADE, OR PROFESSION

CCR Regulations Section 17951-4(a) provides that the net income from a nonresident's business, trade, or profession carried on wholly within this state is California source income. Conversely, none of the net income from a nonresident's business, trade, or profession carried on entirely outside of this state is California source income.

CCR Section 17951-4(b) provides that if a nonresident's business, trade, or profession is conducted within and without California, and the part within California is so separate and distinct from the part without California such that the respective business activities are not part of a unitary business, trade, or profession, only the net income from within California is included in California source income.

**Example 1**

Julie, an Oregon resident, operates a real estate business in California and an unrelated retail business in Oregon.

**Determination:**

Julie includes only the net income from the real estate business as California source income.

If a sole proprietorship, partnership, S corporation, or limited liability company operates within and without California as a unitary business, trade, or profession, we determine the amount of net income derived from sources within California in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act as contained in R&TC

Sections 25120-25139 and their related regulations (CCR Section 17951-4(c), (d), (e) and (f)).

CCR Sections 17951-4(c), (d), (e), and (f) provide that we determine the source of net income that is **not** business income by using the sourcing rules of R&TC Section 17951-17955 and the related regulations.

## 3320 PARTNERSHIPS, S CORPORATIONS, AND CERTAIN TRUSTS

**Nonresidents**

California taxes a nonresident's distributive share of partnership, S corporation, and trust income derived from California sources. Income from a simple trust (one which distributes its income annually) is subject to these rules. Income from other trusts may also be subject to these rules.

The nonresident partner's distributive share of partnership income apportioned to California is California source income. See the Appeal of Lore Pick, 1985-SBE-066, June 25, 1985, and the Appeal of George D. Bittner, 1985-SBE-111, October 9, 1985.

### Example 1

Mary is a nonresident of California and holds a partnership interest in a California partnership. She received a Schedule K-1 from the California partnership that included net income of $10,000 from California sources.

**Determination:**

Mary's $10,000 distributive share of partnership net income has a source in California and is taxable by California.

CCR Regulations Section 17951-4(d)(2) provides that we treat the source of guaranteed payments received by a nonresident partner as a distributive share of partnership income. See the FTB Notice 89-493.

**Part-Year Residents**

If a taxpayer changes residency during a taxable year, we tax the distributive share of partnership, S corporation, and trust income based upon the taxpayer's period of California residency and period of nonresidency during the partnership's or S corporation's taxable year. Income from a simple trust (one which distributes its income annually) is subject to these rules. Income from other trusts may also be subject to these rules.

The allocation of income between the period of residency and the period of nonresidency must be made in a manner that reflects the actual date of realization. In the absence of information that reflects the actual date of realization, the taxpayer must allocate an annual amount on a proportional basis between the two periods, using a daily pro rata method. See Legal Ruling 2003-1 and FTB Publication 1100.

**Example 2**

Harry holds a 50 percent S corporation interest in a Washington S corporation that reports income and losses on a fiscal year ending October 31 of each year. On June 10, 2002, he became a nonresident of California. Harry obtained interim statements from the S corporation that included the following S corporation net income amounts:

| November 1, 2001 - June 9, 2002 | | June 10, 2002 - October 31, 2002 | |
|---|---|---|---|
| Washington net income | $ 5,600 | Washington net income | $ 4,400 |
| California net income | 4,000 | California net income | 2,000 |
| Total net income | $ 9,600 | Total net income | $ 6,400 |

**Determination:**

**Step 1**

Compute the distributive share income based upon periods of California residency and nonresidency during the S corporation's taxable year.

| **Period of Residency** | | **Period of Nonresidency** | |
|---|---|---|---|
| Total net income | $9,600 | California net income | $ 2,000 |
| % interest in S corporation | X 50% | % interest in S corporation | X 50% |
| 2002 distributive share | $ 4,800 | 2002 distributive share | $ 1,000 |

**Step 2**

Compute the distributive share income to include in California taxable income.

| **Taxable year 2002** | **CA taxable income** |
|---|---|
| Distributive share, period of residency | $ 4,800 |
| Distributive share, period of nonresidency | 1,000 |
| Distributive share income, 2002 | $ 5,800 |

**Example 3**

Brian holds a 60 percent interest in a Washington partnership that reports income and losses on a calendar-year basis. On September 22, 2002, he became a nonresident of California. Brian obtained a copy of the partnership tax return for 2002. The total net income from the partnership consisted of the following capital gains on items sold during Brian's periods of California residency and nonresidency:

| January 1, 2002 - September 21, 2002 | | September 22, 2002 – December 31, 2002 | |
|---|---|---|---|
| Sale of WA real property | $ 15,200 | Sale of WA real property | $ 4,400 |
| Sale of stock | 2,000 | Sale of CA real property | 10,300 |
| Total net income | $17,200 | Total net income | $14,700 |

**Step 1**

Compute the distributive share income based upon periods of California residency and nonresidency during the partnership's taxable year.

| **Period of Residency** | | **Period of Nonresidency** | |
|---|---|---|---|
| Total net income | $17,200 | California net income | $ 10,300 |
| % interest in partnership | X 60% | % interest in partnership | X 60% |
| 2002 distributive share | $ 10,320 | 2002 distributive share | $ 6,180 |

**Step 2**

Compute the distributive share income to include in California taxable income.

| **Taxable year 2002** | **CA taxable income** |
|---|---|
| Distributive share, period of residency | $ 10,320 |
| Distributive share, period of nonresidency | 6,180 |
| Distributive share income, 2002 | $ 16,500 |

**Example 4**

Molly holds a partnership interest in a Texas partnership that reports its income and losses on a calendar-year basis. On April 1, 2002, she became a nonresident of California. Molly received a Schedule K-1 from the Texas partnership that included net income of $10,000, comprised of $4,000 from California sources and $6,000 from Texas sources.

**Determination:**

**Step 1**

Determine the number of California resident days and nonresident days during the partnership's taxable year.

| **California Resident Days** | **California Nonresident Days** |
|---|---|
| January 1, 2002, through March 31, 2002 = 90 days | April 1, 2002, through December 31, 2002 = 275 days |

**Step 2**

Prorate the distributive share income based upon periods of California residency and nonresidency during the partnership's taxable year.

| **Period of Residency** | | **Period of Nonresidency** | |
|---|---|---|---|
| Distributive share income from all sources | $10,000 | Distributive share income from California sources | $ 4,000 |
| CA resident days ÷ total days 90 ÷ 365 | X .2466 | Nonresident days ÷ total days 275 ÷ 365 | X .7534 |
| Prorated 2002 distributive share | $ 2,466 | Prorated 2002 distributive share | $ 3,014 |

**Step 3**

Compute the distributive share income to include in California taxable income.

| **Taxable year 2002** | **CA taxable income** |
|---|---|
| Distributive share, period of residency | $ 2,466 |
| Distributive share, period of nonresidency | 3,014 |
| Distributive share income, 2002 | $ 5,480 |

**Example 5**

Karen holds an S corporation interest in a Florida S corporation that reports income and losses on a fiscal year ending May 31 of each year. On February 1, 2002, she became a resident of California. Karen received a Schedule K-1 from the Florida S corporation for fiscal year ending May 31, 2002, that included net income of $10,000, comprised of $4,000 from California sources and $6,000 from Florida sources.

**Determination:**

**Step 1**

Determine the number of California resident days and nonresident days during the S corporation's taxable year.

| **California Resident Days** | **California Nonresident Days** |
|---|---|
| Feb. 1, 2002, through May 31, 2002 = 120 days | June 1, 2001, through Jan. 31, 2002 = 245 days |

**Step 2**

Prorate the distributive share income based upon periods of California residency and nonresidency during the S corporation's taxable year.

| **Period of Residency** | | **Period of Nonresidency** | |
|---|---|---|---|
| Distributive share income from all sources | $10,000 | Distributive share income from California sources | $ 4,000 |
| CA resident days ÷ total days (120 ÷ 365) | X .3288 | Nonresident days ÷ total days (245 ÷ 365) | X .6712 |
| Prorated 2002 distributive share | $ 3,288 | Prorated 2002 distributive share | $ 2,685 |

**Step 3**

Compute the distributive share income to include in California taxable income.

| **Taxable year 2002** | **CA taxable income** |
|---|---|
| Distributive share, period of residency | $ 3,288 |
| Distributive share, period of nonresidency | 2,685 |
| Distributive share income, 2002 | $ 5,973 |

**Example 6**

Jane is the sole beneficiary of a simple trust that reported her distributive share income for the short period of January 1, 2002, through September 30, 2002. On April 1, 2002, she became a resident of California. Jane received a Schedule K-1 from the trust that included net income of $10,000, comprised of $4,000 from California sources and $6,000 from Nevada sources.

**Determination:**

**Step 1**

Determine the number of California resident days and nonresident days during the trust's taxable year.

| **California Resident Days** | **California Nonresident Days** |
|---|---|
| April 1, 2002, through September 30, 2002 = 183 days | January 1, 2002, through March 31, 2002 = 90 days |

**Step 2**

Prorate the distributive share income based upon periods of California residency and nonresidency during the trust's taxable year.

| **Period of Residency** | | **Period of Nonresidency** | |
|---|---|---|---|
| Distributive share income from all sources | $10,000 | Distributive share income from California sources | $ 4,000 |
| CA resident days ÷ total days (183 ÷ 273) | X .6703 | Nonresident days ÷ total days (90 ÷ 273) | X .3297 |
| Prorated 2002 distributive share | $ 6,703 | Prorated 2002 distributive share | $ 1,319 |

**Step 3**

Compute the distributive share income to include in California taxable income.

| **Taxable year 2002** | **CA taxable income** |
|---|---|
| Distributive share, period of residency | $ 6,703 |
| Distributive share, period of nonresidency | 1,319 |
| Distributive share income, 2002 | $ 8,022 |

## 3330 GAINS AND LOSSES FROM THE SALE OR TRADE OF BUSINESS PROPERTY

When a taxpayer sells property used in a trade or business or certain involuntary conversions (Internal Revenue Code Section 1231 property), losses are netted against gains. If Section 1231 losses exceed Section 1231 gains, the losses receive ordinary tax treatment. If Section 1231 gains exceed Section 1231 losses, the gains receive capital gain tax treatment. Section 1231 gains and losses retain this characterization regardless of whether the taxpayer changes residency status.

For purposes of computing California taxable income, net only the California source Section 1231 gains and losses.

**Example 1**

Dan is a resident of Washington. In 2002, his California and non-California source Section 1231 gains and losses included a $3,000 California gain, a $2,000 California loss, a $4,000 Washington gain, and a $5,000 Washington loss.

**Determination:**

Based upon the netting of his total and California source Section 1231 gains and losses, determine Dan's capital gain or ordinary loss as follows:

| Taxable year 2002 | Total taxable income | CA taxable income |
|---|---|---|
| CA Section 1231 gain | $ 3,000 | $ 3,000 |
| CA Section 1231 loss | (2,000) | (2,000) |
| WA Section 1231 gain | 4,000 | |
| WA Section 1231 loss | (5,000) | |
| Capital gain | $ 0 | $ 1,000 |

**Example 2**

Susan is a resident of Florida. In 2002, her California and non-California source Section 1231 gains and losses included a $2,500 California gain, a $3,000 California loss, a $1,000 Florida gain, and a $500 Florida loss.

**Determination:**

Based upon the netting of her total and California source Section 1231 gains and losses, determine Susan's capital gain or ordinary loss as follows:

| Taxable year 2002 | Total taxable income | CA taxable income |
|---|---|---|
| CA Section 1231 gain | $ 2,500 | $ 2,500 |
| CA Section 1231 loss | (3,000) | (3,000) |
| FL Section 1231 gain | 1,000 | |
| FL Section 1231 loss | ( 500) | |
| Ordinary loss | $ 0 | $ ( 500) |

## 3340 DEFERRED GAINS AND LOSSES (LIKE-KIND EXCHANGES)

When a taxpayer exchanges one kind of property for the same kind of property under the requirements of Internal Revenue Code Section 1031, the taxpayer realizes a gain or loss on the transaction and defers paying tax on the gain or claiming the loss until the property is sold or otherwise disposed of. A gain or loss from the sale or exchange of real or tangible personal property located in California is sourced to California at the time the gain or loss is realized.

### California Property Exchanged for Out-of-State Property

If a nonresident exchanges real or tangible property located within California for real or tangible property located outside California, the realized gain or loss will be sourced to California. Taxation will not occur until the gain or loss is recognized. This requires the taxpayer to keep track of the deferred California sourced gains and losses to report them to California in the year the taxpayer sells or otherwise disposes of the property received in the exchange.

**Example 1**

As a resident of Texas, Jim exchanged a condominium located in California for like-kind property located in Texas. He realized a gain of $15,000 on the exchange that was properly deferred under IRC Section 1031. Jim then sold the Texas property in a nondeferred transaction and recognized a gain of $20,000.

**Determination:**

The $15,000 deferred gain (the lesser of the deferred gain or the gain recognized at the time Jim disposed of the Texas property) has a source in California and is taxable by California.

### Out-of-State Property Exchanged for California Property

If a taxpayer exchanges real or tangible property located outside California for real or tangible property located within California, the gain recognized when the taxpayer sells or otherwise disposes of the California property in a nondeferred transaction has a California source and is taxable by California.

**Example 2**

As a resident of Nevada, Harry exchanged Nevada business property for like-kind California business property. He realized a $10,000 gain on the exchange that was properly deferred under IRC Section 1031. Harry then sold the California business property in a nondeferred transaction and recognized a gain of $50,000.

**Determination:**

Because the property is located in California, the $50,000 gain has a California source and is taxable by California.

**Example 3**

While a resident of Kansas, Betty exchanged real property located in Kansas for like-kind real property located in California. She realized a $12,000 gain on the exchange that was properly deferred under IRC Section 1031. Betty then became a California resident and, while a resident, she sold the California property in a nondeferred transaction and recognized a gain of $40,000.

**Determination:**

California taxes the $40,000 gain because Betty was a California resident at the time of the sale. If she paid tax to Kansas on the $12,000 deferred gain, she is allowed a credit for taxes paid.

## 3350 INTANGIBLE PERSONAL PROPERTY

R&TC Section 17952 states that 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 California.

The California Supreme Court determined in Merton L. Miller v. Charles J. McColgan, (1941) 17 Cal. 2d 432, that gains from stock had their source in the stock itself and the situs of the stock was the residence of its owner. The court applied the doctrine of **mobilia sequuntur personam**, which means "movables follow the person."

**Example 1**

Beverly, a nonresident, owns stock in a California corporation from which she received $7,000 in dividends.

**Determination:**

Dividends have a source in the owner's state of residence. Therefore, the dividends Beverly received are not California source income.

**Example 2**

Stephanie moved from Nevada and became a California resident on May 1, 2001. However, she kept her money in a bank account in Nevada. From May 1, 2001, to December 31, 2001, the Nevada bank account earned $900.

**Determination:**

Interest income generally has a source in the recipient's state of residence. Because Stephanie became a California resident on May 1, 2001, the interest earned by Stephanie from May 1, 2001, to December 31, 2001, is considered California source income.

**Example 3**

During 2000, Ed was a part-year resident. He sold 500 shares of stock at a $10,000 gain after becoming a California resident.

**Determination:**

The gain on the sale of the stock is taxable by California because Ed was a California resident when he sold the stock.

A business situs is acquired in California if the property is employed as capital in California. A business situs is also acquired in California if 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 in this state. The entire income, including the gain from the sale of such an asset, is income from California sources. Examples are pledging an intangible asset as security for a loan in connection with a California business or maintaining a bank account for payment of expenses related to business activities in California. See CCR Regulations Section 17952(c).

The source of gains and losses from the sale or other disposition of intangible personal property is determined at the time of the sale or disposition of that property. See CCR Regulations Section 17952(d).

**Example 4**

Robert, a life-long California resident, reported a capital loss carryover from the sale of securities for tax year 2002. On January 1, 2003, Robert permanently moved to Florida. On June 1, 2003, Robert sold vacant land located in California and realized a capital gain from the sale.

**Determination:**

The capital gain from the sale of land located in California is sourced to California. Because Robert was a California resident at the time he sold the securities, the source of the capital loss carryover is California. Robert may offset the California source capital gain from the sale of land with the California source capital loss carryover from the sale of securities.

R&TC Section 17955 provides that income of a nonresident from qualifying investment securities is not income from sources within this state if the taxpayer's only contact with this state is through a broker, dealer, or investment advisor located in this state.

Sale of a partnership interest is considered a sale of an intangible asset. See the Appeal of Amyas and Evelyn P. Ames et al., 1987-SBE-042, June 17, 1987.

## 3360 CAPITAL GAINS AND LOSSES

### Always a Nonresident

If a taxpayer has always been a nonresident of California, the capital loss carryovers and capital loss limitations are based only upon California source income and loss items in order to compute California taxable income.

**Example 1**

Jill has always been a New York resident. In 2002, her California and non-California source capital gains and losses included California capital gains of $2,000, California capital losses of $6,000, New York capital gains of $5,000, and New York capital losses of $2,000. She had no capital loss carryovers prior to 2002.

**Determination:**

Net Jill's capital gains and losses to determine the capital losses allowed in 2002 (the $3,000 limitation applies) and the capital loss carryover to 2003.

| Taxable year 2002 | Total taxable income | CA taxable income |
|---|---|---|
| CA capital gain | $ 2,000 | $ 2,000 |
| CA capital loss | (6,000) | (6,000) |
| NY capital gain | 5,000 | |
| NY capital loss | (2,000) | |
| Total | $ (1,000) | $(4,000) |
| Capital loss allowed in 2002 | 1,000 | 3,000 |
| Capital loss carryover to 2003 | $ 0 | $(1,000) |

**Change of Residency to California (Move-In)**

If a taxpayer has capital loss carryovers and was a nonresident of California in prior years, the capital loss carryovers need to be restated as if the taxpayer had been a California resident for all prior years.

**Example 2**

Assume the same facts as Example 1. On January 1, 2003, Jill becomes a California resident. During 2003, she sells property located in Wyoming for a capital gain of $5,000 and incurs a $4,000 capital loss from the sale of property located in California.

**Determination:**

**Step 1**

Restate Jill's 2002 capital loss carryover as if she had been a California resident for all prior years.

| **2002 Restatement** | **Total taxable income** |
|---|---|
| CA capital gain | $ 2,000 |
| CA capital loss | (6,000) |
| NY capital gain | 5,000 |
| NY capital loss | (2,000) |
| Total | $ (1,000) |
| Capital loss allowed in 2002 | 1,000 |
| Capital loss carryover to 2003 | $ 0 |

**Step 2**

Net Jill's capital gains and losses to determine the amount of capital gain income to include in total taxable income.

| **Taxable year 2003** | **Total taxable income** |
|---|---|
| CA capital loss | $ (4,000) |
| WY capital gain | 5,000 |
| Capital loss carryover | 0 |
| Capital gain income | $1,000 |

**Change of Residency from California (Move-Out)**

If a taxpayer has capital loss carryovers and becomes a nonresident of California, the capital loss carryovers need to be restated as if the taxpayer had been a nonresident of California for all prior years.

**Example 3**

Assume the same facts as Examples 1 and 2. On January 1, 2004, Jill becomes a nonresident of California again. During 2004, she sells property located in Texas for a capital gain of $8,000, sells property located in California for a $9,000 capital gain, and incurs a $5,000 capital loss from the sale of property located in California.

**Determination:**

**Step 1**

Restate Jill's capital loss carryovers as if she had been a nonresident of California for all prior years by netting her capital gains and losses from California sources only.

| **2002 Restatement** | **Total taxable income** | **CA taxable income** |
|---|---|---|
| CA capital gain | $ 2,000 | $ 2,000 |
| CA capital loss | (6,000) | (6,000) |
| NY capital gain | 5,000 | |
| NY capital loss | (2,000) | |
| Total | $(1,000) | $(4,000) |
| Capital loss allowed in 2002 | 1,000 | 3,000 |
| Capital loss carryover to 2003 | $ 0 | $(1,000) |

| **2003 Restatement** | **Total taxable income** | **CA taxable income** |
|---|---|---|
| CA capital loss, 2003 | $ (4,000) | $ (4,000) |
| WY capital gain | 5,000 | |
| Capital loss carryover from 2002 | | (1,000) |
| Capital gain or loss | $ 1,000 | $ (5,000) |
| Capital loss allowed in 2003 | | 3,000 |
| Capital loss carryover to 2004 | $ 0 | $ (2,000) |

**Step 2**

Net Jill's capital gains and losses to determine the amount of capital gain income to include in total taxable income and California taxable income.

| **Taxable year 2004** | **Total taxable income** | **CA taxable income** |
|---|---|---|
| CA capital gain | $ 9,000 | $ 9,000 |
| CA capital loss | (5,000) | (5,000) |
| TX capital gain | 8,000 | |
| Total | $ 12,000 | $ 4,000 |
| Capital loss carryover from 2003 | 0 | (2,000) |
| Capital gain income | $ 12,000 | $ 2,000 |

### Part-Year Resident

If a taxpayer changes residency during the taxable year, compute income and deductions using resident rules for the period of the year the taxpayer was a California resident and nonresident 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 and 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.

### Example 4

Peter became a California resident on July 1, 2002. His total and California source capital gains and losses for 2002 are as follows:

| **Before July 1, 2002** | | **After July 1, 2002** | |
|---|---|---|---|
| Total capital gains | $ 10,000 | Total capital gains | $ 8,000 |
| CA source capital gains | 7,000 | CA source capital gains | 4,000 |
| Total capital losses | (2,000) | Total capital losses | (3,000) |
| CA source capital losses | (1,000) | CA source capital losses | (3,000) |

His capital loss carryover from 2001 was $7,000, as if he had been a California resident for all prior years and $5,000, as if he had been a nonresident for all prior years.

### Determination:

### Step 1

Net Peter's total capital gains and losses for the period of residency and his California source capital gains and losses for the period of nonresidency.

| | |
|---|---|
| CA capital gains, before July 1, 2002 | $ 7,000 |
| CA capital losses, before July 1, 2002 | (1,000) |
| Total capital gains, after July 1, 2002 | 8,000 |
| Total capital losses, after July 1, 2002 | (3,000) |
| Capital gain before carryover losses | $ 11,000 |

**Step 2**

Prorate Peter's capital loss carryover amounts based upon periods of California residency and nonresidency during 2002.

| **Period of Residency** | | **Period of Nonresidency** | |
|---|---|---|---|
| 2001 carryover, as if a CA resident for all prior years | $(7,000) | 2001 carryover, as if a nonresident for all prior years | $(5,000) |
| CA resident days ÷ total days (184 ÷ 365) | X .5041 | Nonresident days ÷ total days (181 ÷ 365) | X .4959 |
| Prorated 2001 capital loss carryover | $(3,529) | Prorated 2001 capital loss carryover | $(2,479) |

**Step 3**

Compute Peter's capital gain or loss to include in California taxable income.

| **Taxable year 2002** | **CA taxable income** |
|---|---|
| Capital gain before carryover losses | $11,000 |
| Capital loss carryover, resident period | (3,529) |
| Capital loss carryover, nonresident period | (2,479) |
| Capital gain, 2002 | $ 4,992 |

## 3400 COMPENSATION FOR PERSONAL SERVICES

Internal Revenue Code Section 61(a) (1) defines gross income to include compensation for services, including fees, commissions, fringe benefits, and similar items. This section of the manual includes the following topics:

| | |
|---|---|
| RSTM 3410 | Taxpayer Becomes a California Resident (Move-In) |
| RSTM 3420 | Taxpayer Becomes a Nonresident (Move-Out)/Taxpayer is a Nonresident for the Entire Year |
| RSTM 3430 | Allocation of Compensation |
| RSTM 3440 | Sick Leave, Vacation Pay, Bonuses, and Severance Pay |
| RSTM 3450 | Deferred Compensation Plans |
| RSTM 3460 | Payments for Release from Contractual Obligations |
| RSTM 3470 | Tax Equalization Payments |
| RSTM 3480 | Moving Expenses |
| RSTM 3490 | Restricted Stock |

## 3410 Taxpayer Becomes a California Resident (Move-In)

If a taxpayer is a California resident when compensation is received, the compensation is taxable by California.

**Example 1**

Bill lived and worked in Kentucky until April 30, 2002. He permanently moved to California on May 3, 2002. On May 7, 2002, Bill received his last monthly paycheck of $3,000 in the mail from his Kentucky employer.

**Determination:**

The wage income of $3,000 is taxable income because Bill was a California resident when he received the paycheck. If Bill also paid tax to Kentucky, he is allowed an Other State Tax Credit on this double-taxed income. See RSTM 3900.

## 3420 Taxpayer Becomes a Nonresident (Move-out)/Taxpayer is a Nonresident for the Entire Year

In determining whether compensation is California source income after a taxpayer becomes a nonresident during the year or is a nonresident for the entire year, we tax on a source basis.

The critical factor in determining the source of income from personal services is not the residence of the taxpayer, the place where the contract for services is entered into, or the place of payment. It is the place where the services are actually performed. See the Appeal of Janice Rule, 1976-SBE-099, October 6, 1976; Ingram v. Bowers, 47 F. 2d 925, aff'd. 57 F. 2d 65; Appeal of Charles W. and Mary D. Perelle, 1958-SBE-057, December 16, 1958; and Appeal of Robert C. and Marian Thomas, 1955-SBE-006, April 20, 1955.

**Example 1**

Christine lives and works in Minnesota. She is temporarily assigned to California for three months to complete a project. She continues to receive her paycheck from the Minnesota headquarters of her employer. She earns $5,000 a month.

**Determination:**

The $15,000 Christine earns while working in California is California source income and taxable by California.

**Example 2**

Steven lives and works in California. He is temporarily assigned to New York for five months to complete a project. He continues to receive his paycheck from the California headquarters of his employer. He earns $5,000 a month.

**Determination:**

The $25,000 Steven earns while working in New York is not California source income. He did not perform the underlying services in California. However, because California residents are taxed on income from all sources, the $25,000 Steven earns in New York is taxable by California. If Steven also pays tax to New York, he is allowed an Other State Tax Credit on this double-taxed income. See RSTM 3900.

**Example 3**

Jamie lived and worked exclusively in California until she retired on December 31, 2002. She moved to Nevada on January 1, 2003. Her former California employer pays its employees on the 5th of every month. On January 10, 2003, Jamie received in the mail her last paycheck of $4,000 from her former California employer.

**Determination:**

The $4,000 of compensation is taxable by California because the income has a source in California, the state where Jamie performed her services.

## 3430 Allocation of Compensation

When a part-year resident or a nonresident receives compensation for services performed within and outside California, we must determine the amount received for services performed in this state.

R&TC Section 17954 provides that gross income from sources within and without California shall be allocated and apportioned under rules and regulations prescribed under our rules and regulations.

CCR Regulations 17951-5 provides the following rules for allocating wages, salaries, and other compensation to determine the amount attributable to California sources:

| **Category** | **Allocation Method** |
|---|---|
| Salesmen, agents, and other employees receiving commissions dependent upon volume of business. CCR Section 17951-5(a)(1) | Business transacted in CA<br>Business transacted everywhere |
| Employed in CA at intervals throughout the year and paid on a regular basis. CCR Section 17951-5(b) | Working days in CA<br>Working days everywhere |
| Employed in CA at intervals throughout the year and paid on a mileage basis. CCR Section 17951-5(b) | Miles in CA<br>Miles everywhere |
| Actors, singers, entertainers, etc. CCR Section 17951-5(a)(2) | Gross amounts received for performances in CA |
| Attorneys, accountants, doctors, etc. CCR Section 17951-5(a)(3) | Fees/ compensation received for services performed in CA |
| Employed continuously in CA for a definite portion of the year. CCR Section 17951-5(a)(4) | Total compensation for period employed in CA |
| Employed in CA at intervals throughout the year and | Reasonable manner |

paid on some other basis. CCR Section 17951-5(b)

The Board of Equalization and the courts have issued several decisions on apportioning compensation received for services performed within and without California. Typically, the decision focuses on determining the number of working days within and without California. See the: Appeal Of Estate Of Marilyn Monroe, Deceased, 1975-SBE-032, April 22, 1975. And the Appeal of Sam and Betty Spiegel, 1986-SBE-121, June 10, 1986. In the Appeal of Louis and Betzi Akerstrom, 1960-SBE-009, May 17, 1960, the Board used days in California divided by 365 because the taxpayer took very little vacation.

Many appeals have been heard on allocating professional athletes' income. In the Appeal of Joseph Barry Carroll, 1987-SBE-026, April 7, 1987, the Board approved the use of the "duty days" method for professional athletes. "Duty days" generally include all working days from the beginning of official pre-season training through the last game in which the team competes. The California Court of Appeals (Court) affirmed this method in Marc D. Wilson et al. v FTB, 20 Cal. App. 4th 1441 (1993).

A decision related to allocating compensation received by a nonresident for services performed within and without California is Paul L. and Joanne W. Newman v. FTB, 208 Cal. App. 3d 972 (1989). The case focused on the salary received by the actor Paul Newman for filming the movie "The Sting." The court determined that his salary should be allocated based on the ratio of duty days in California over total duty days. The court included all filming and "on-call" days in the formula.

### Airline Employees

Pursuant to 49 U.S.C. Section 40116(f)(2)(B), California does not tax the wages of a nonresident airline employee (i.e., pilot, copilot, flight attendant) unless more than 50 percent of the individual's scheduled flight time is in California.

If more than 50 percent of the scheduled flight time is in California, California allocates the wages as follows:

$$\text{Total wages} \times \frac{\text{Scheduled flight time in California}}{\text{Total scheduled flight time}} = \text{California source wages}$$

### Railroad Employees and Truck Drivers

Pursuant to 49 U.S.C. Sections 11502(a) and 14503(a), the wages of nonresident railroad employees or truck drivers, who regularly perform their assigned duties in two or more states, are sourced to their state of residence.

### Military Personnel

Pursuant to the Service members Civil Relief Act (50 U.S.C. Appen. Section 571), R&TC Section 17140.5 (c) provides:

- California does not tax the military compensation of a service member not domiciled in California.
- California may not use the military compensation of a service member not domiciled in California to increase the tax liability imposed on other income of military service members or their spouses.

We tax all nonmilitary income from a California source regardless of whether or not a California domicile is established.

These special rules apply to military personnel only. They do not apply to civilian employees of the military.

## 3440 Sick Leave, Vacation Pay, Bonuses, and Severance Pay

### Nonresidents

Sick leave, vacation pay, and bonuses earned by a nonresident for services performed in California are considered California source income. See the Appeal of Edwin O. and Wanda L. Stevens, 1986-SBE-100, May 6, 1986.

Severance pay earned by a nonresident for services performed in California prior to the nonresident's separation from employment is also California source income.

### Residents

If a taxpayer is a California resident when sick leave, vacation pay, and bonuses are received, the income is taxable by California.

### Example 1

Richard lived and worked in Maine until June 30, 2002, the date of his employer's taxable year-end. He permanently moved to California on July 5, 2002. On July 20, 2002, Richard received a bonus check of $10,000 from his former Maine employer.

### Determination:

The bonus income of $10,000 is taxable income because Richard was a California resident when he received the bonus check. If Richard also paid tax to Maine on this bonus, he is allowed an Other State Tax Credit. See RSTM 3900.

## 3450 Deferred Compensation Plans

Payments to employees from nonqualified deferred compensation plans, such as performance incentive plans, long-term incentive plans, and deferred bonus plans (including stock appreciation rights and phantom stock) are considered compensation for services under the definition of Internal Revenue Code Section 61(a)(1)/R&TC Section 17071.

We do not distinguish between the portion of a payment from a deferred compensation plan deemed to be distributed from employer contributions and that deemed to be from the plan earnings. The fact that the earnings were accumulated and distributed does not change the nature of the income.

See RSTM 3410, RSTM 3420, and RSTM 3430 for determining the California taxation of compensation for services.

## 3460 Payments for Release from Contractual Obligations

Payment for release from a contractual obligation to perform services in California is California source income. When a taxpayer is paid not to do something in California, it stands in the same footing as if the taxpayer actually performed the services. See Legal Ruling 133.

## 3470 Tax Equalization Payments

If a taxpayer is a California resident when a tax equalization payment is received, the tax equalization payment is taxable by California.

**Example 1**
Esther lived and worked in Germany until March 31, 2002. On August 1, 2002, Esther permanently moved to California and on August 15, 2002, she received her tax equalization payment from her former German employer.

**Determination:**

The tax equalization payment is taxable by California because Esther was a California resident when she received the payment.

## 3480 Moving Expenses

Reimbursement for moving expenses is included in California source income if the taxpayer is moving into California and the payment relates directly to the taxpayer's California employment. The payment represents compensation for services to be performed in this state. See the Appeal of William H. Harmount and Estate of Dorothy E. Harmount, Deceased, 1977-SBE-121, September 28, 1977, and Appeal of Peter and Anita Berk, 1984-SBE-101, June 27, 1984. We do not treat reimbursed out-bound moving expenses as California source income.

## 3490 Restricted Stock

Generally, a taxpayer recognizes taxable wage income upon the vesting of restricted stock. The taxable wage income is the difference between the fair market value of the stock on the vesting date and the price the taxpayer paid for the stock.

If a taxpayer pays taxes on this wage income to California and another state, the taxpayer may be allowed an Other State Tax Credit (OSTC) on this double-taxed income. See RSTM 3900.

**California Resident on Vesting Date**

If a taxpayer is a California resident on the date the stock vests, California taxes the difference between the fair market value of the stock on the vesting date and the price the taxpayer paid for the stock because the taxpayer is a California resident when the income is recognized.

**Example 1**

On March 1, 2003, while a resident of Maine, Brad purchased stock from his employer that was subject to substantial risk of forfeiture for a 5-year period. On June 1, 2007, Brad's employer permanently transferred him to California. On March 1, 2008, Brad's stock vested.

**Determination:**

Because Brad was a California resident when the stock vested, the difference between the fair market value of the shares on March 1, 2008, and the price Brad paid for the stock on March 1, 2003, is wage income taxable by California.

If Brad also paid tax to Maine, he is allowed an OSTC against California taxes paid to Maine on this double-taxed income.

**Nonresident of California on Vesting Date**

If a taxpayer is a nonresident of California on the date the stock vests, the character of the income attributable to the vesting is compensation for services rendered. California taxes the income to the extent the taxpayer performed services in this state.

**All service performed within California:**

If a taxpayer performs services for a corporation entirely within California but the stock vests after the taxpayer terminates employment and becomes a nonresident, the income attributable to the difference between the fair market value of the stock on the vesting date and the price the taxpayer paid for the stock has a source in California, the location where the taxpayer performed the services.

**Example 2**

On February 1, 2004, while a resident of California, Judy purchased stock from her employer that was subject to substantial risk of forfeiture for a 3-year period. Judy performed all of her services in California from February 1, 2004, to December 31, 2006, the date she left the company and permanently moved to Wyoming. On February 1, 2007, Judy's stock vested.

**Determination:**

The difference between the fair market value of the stock on February 1, 2007, and the price Judy paid for the restricted stock on February 1, 2004, is characterized as compensation for services having a source in California, the state where Judy performed all of her services.

**Services performed within and outside California:**

If a taxpayer performed services both within and without California, the taxpayer must allocate to California that portion of total compensation reasonably attributed to services performed in this state (CCR Regulations Section 17951-5).

One reasonable method is an allocation based on the time worked. The period of time the taxpayer performed services includes the total amount of time from the purchase of the restricted stock to the vesting date (or the date the taxpayer's employment ended, if earlier).

The allocation ratio is:

$$\frac{\text{California workdays from purchase date to vesting date}}{\text{Total workdays from purchase date to vesting date}}$$

Income taxable by California = Total income from restricted stock x Allocation ratio

**Example 3**

On November 1, 2003, while a resident of California, Bonnie purchased stock from her employer that was subject to substantial risk of forfeiture for a 4-year period. On October 1, 2007, she left the company and permanently moved to Texas. From November 1, 2003, through October 1, 2007, Betty worked for the company a total of 700 days in California and 300 days in other states. On November 1, 2007, the stock vested.

**Determination:**

The difference between the fair market value of Bonnie's stock on November 1, 2007, and the price she paid for the restricted stock on November 1, 2003, is characterized as compensation for services. The total number of workdays from the purchase date to the vesting date equal 1,000 (700 California workdays + 300 other state workdays). The allocation ratio is .70 (700 California workdays ÷1,000 total workdays). Therefore, 70 percent of Bonnie's income from the restricted stock is taxable by California.

## 3500 EMPLOYEE STOCK OPTIONS



## 3510 Introduction

An employee stock option is the right or privilege granted by a corporation to purchase the corporation's stock at a specified price during a specified period.

Stock option plans that meet the requirements of IRC Section 421 - IRC Section 424/R&TC Section 17501-17502 are referred to as **statutory** stock options; those that do not are referred to as **nonstatutory** (or nonqualified) stock options and are governed by IRC Section 83/R&TC Section 17081.

Statutory stock options consist of incentive stock options and employee stock purchase plans. Nonstatutory stock options are all other options. California law conforms to federal law concerning the taxation of statutory and nonstatutory stock options.

In addition to these stock options, R&TC Section 17502 provides for California qualified stock options.

This section of the manual provides information on the taxation of the various types of stock options and how to determine what stock option income is taxable by California when a taxpayer changes his or her residency status.

**Key terms**

| | |
|---|---|
| Grant date | The date the company grants the option to the employee. |
| Option price | The price the employee will pay for the stock (also referred to as the grant price or exercise price). |
| Exercise date | The date the employee purchases the stock at the option price. |
| Qualifying disposition | A disposition that meets the following IRC Section 422 or IRC Section 423 holding period requirements:<br>• No sale of the stock within 2 years from the grant date of the option.<br>• No sale of the stock within 1 year after the date the taxpayer exercises the option. |
| Disqualifying disposition | A disposition that does not meet the holding period requirements of IRC Section 422 or IRC Section 423. |

## 3520 Nonstatutory Stock Options

Generally, a taxpayer recognizes taxable wage income upon the exercise of a nonstatutory stock option. The taxable wage income is the difference between the fair market value of the stock on the exercise date and the option price.

If a taxpayer pays taxes on this wage income to California and another state, the taxpayer may be allowed an Other State Tax Credit (OSTC) on this double-taxed income. See RSTM 3900.

### California Resident on Exercise Date

If a taxpayer exercises a nonstatutory stock option while a California resident, California taxes the difference between the fair market value of the shares on the exercise date and the option price because the taxpayer is a California resident when the income is recognized. See the Appeal of Earl R. and Alleene R. Barnett, 1980-SBE-122, October 28, 1980.

**Example 1**

On March 1, 1997, while a resident of Michigan, Fred was granted nonstatutory stock options. On June 1, 2001, he retired and permanently moved to California. On August 1, 2001, Fred exercised his options.

**Determination:**

Because Fred was a California resident when the nonstatutory stock option income is recognized the difference between the fair market value of the shares on August 1, 2001, and the option price is wage income taxable by California. If Fred also paid tax to Michigan, he is allowed an OSTC against California taxes paid to Michigan on this double-taxed income.

**Nonresident of California on Exercise Date**

If a taxpayer exercises a nonstatutory stock option while a nonresident, the character of the stock option income recognized is compensation for services rendered. California taxes the income to the extent the taxpayer performed services in this state. See the Appeal of Charles W. and Mary D. Perelle, 1958-SBE-057, December 17, 1958.

**All service performed within California:**

If a taxpayer performs services for the corporation entirely within California but exercises the option after terminating employment and becoming a nonresident, the difference between the fair market value of the stock on the exercise date and the option price has a source in California, where the taxpayer performed the services.

**Example 2**

On February 1, 1998, while a resident of California, Joan was granted nonstatutory stock options. Joan performed all of her services in California from February 1, 1998, to May 1, 2001, the date she left the company and permanently moved to Texas. On June 1, 2001, Joan exercised her nonstatutory stock options.

**Determination:**

The difference between the fair market value of the shares on June 1, 2001, and the option price is characterized as compensation for services having a source in California, the state where Joan performed all of her services.

**Services performed within and outside California:**

If a taxpayer performed services both within and without California, the taxpayer must allocate to California that portion of total compensation reasonably attributed to services performed in this state (CCR Regulations Section 17951-5).

One reasonable method is an allocation based on the time worked. The period of time the taxpayer performed services includes the total amount of time from the grant date to the exercise date (or the date the taxpayer's employment ended, if earlier).

The allocation ratio is:

California workdays from grant date to exercise date

Total workdays from grant date to exercise date

Income taxable by California = Total stock option income x Allocation ratio

**Example 3**

On November 1, 1997, while a resident of California, Betty was granted nonstatutory stock options. On November 1, 2001, she left the company and permanently moved to Florida. From November 1, 1997, through November 1, 2001, Betty worked for the company a total of 700 days in California and 300 days in other states. On December 1, 2001, she exercised her nonstatutory stock options.

**Determination:**

The difference between the fair market value of Betty's shares on December 1, 2001, and the option price is stock option income characterized as compensation for services. The total number of workdays from grant date to exercise date equal 1,000 (700 California workdays + 300 other state workdays). The allocation ratio is 70 (700 California workdays ÷1,000 total workdays). Therefore, 70 percent of Betty's total stock option income is taxable by California.

## 3530 Incentive Stock Options

### Qualifying Disposition

Internal Revenue Code Section 422 provides for the tax deferral of income from the grant or exercise of an incentive stock option by an employee. Capital gain or loss is recognized when the stock is sold if the holding period requirements under IRC Section 422 are met.

### Disqualifying Disposition

A disqualifying disposition results when the stock is sold before meeting the holding period requirements. The difference between the fair market value (or the sale price, if lower) of the stock on the exercise date and the option price is treated as ordinary income (wages). The increase between the stock's fair market value (FMV) on the sale date and the exercise date is a capital gain (Proposed Treas. Reg. 1.422A-1(b) (3)).

**Incentive Stock Option Tax Treatment Summary Table**

| Disposition Type | Computation | Character |
|---|---|---|
| Qualifying disposition: | Sales price minus option price | Capital gain |
| Disqualifying disposition: Sales price > FMV on exercise date | FMV on exercise date minus option price | Ordinary income |
| | Sales price minus FMV on exercise date | Capital gain |
| Disqualifying disposition: Sales price < FMV on exercise date | Sales price minus option price | Ordinary income |

If a taxpayer pays taxes on this wage income to California and another state, the taxpayer may be allowed an Other State Tax Credit on this double-taxed income. See RSTM 3900.

### Alternative Minimum Tax

For federal and California Alternative Minimum Tax (AMT), stock acquired through the exercise of an incentive stock option must be treated as if the option were a nonstatutory stock option. This means that a taxpayer must generally include as an AMT adjustment the difference between the fair market value of the stock on the exercise date and the option price in the year the option is exercised.

The AMT basis in the stock the taxpayer acquired from exercising the incentive stock option is increased by the amount of the adjustment. The taxpayer may be allowed an AMT credit in a subsequent year.

No AMT adjustment is required if the taxpayer disposes of the stock in the same year he or she exercised the option.

### California Resident on Date of Stock Sale

### Qualifying Disposition

If a taxpayer exercises an incentive stock option while a nonresident of California and later sells the stock in a qualifying disposition at a gain while a California resident, the resulting capital gain is taxable by California because the taxpayer is a California resident when the stock is sold.

**Example 1**

On February 1, 1997, while a resident of Ohio, Peter was granted incentive stock options. On April 1, 2000, he exercised his options. On September 1, 2001, Peter permanently moved to California and sold his stock on October 15, 2001, for a gain.

**Determination:**

Because Peter was a California resident when he sold the stock, the resulting capital gain is taxable by California.

### Disqualifying Disposition

If a taxpayer exercises an incentive stock option while a nonresident of California and later sells the stock in a disqualifying disposition while a California resident, the resulting wage income and capital gain (if applicable) are taxable by California because the taxpayer is a California resident when the stock is sold.

**Example 2**

On February 1, 1997, while a resident of Ohio, Sally was granted incentive stock options. On April 1, 2001, she exercised her options. On June 1, 2001, Sally permanently moved to California and sold her stock on October 1, 2001. The sale price is greater than the fair market value of the stock on the exercise date.

**Determination:**

The resulting wage income and capital gain is taxable by California because Sally was a California resident on the date she sold the stock. If Sally also paid tax to Ohio on the wage income, she is allowed an Other State Tax Credit on this double-taxed income.

## Nonresident of California on Date of Stock Sale

### Qualifying Disposition

If a taxpayer exercises an incentive stock option while a California resident or a nonresident and later sells the stock in a qualifying disposition while a nonresident, the income is characterized as income from the sale or disposition of intangible personal property having a source in the taxpayer's state of residence at the time the stock is sold. Accordingly, the taxpayer is not subject to regular tax by California even though the services that gave rise to the grant may have been performed in this state.

An AMT adjustment must be made in the year the taxpayer exercises the incentive stock option. The source of the adjustment is determined in the same manner as income from the exercise of nonstatutory stock options for regular tax purposes.

### Example 3

On March 1, 1998, Mark was granted an incentive stock option. On March 1, 2000, he exercised his option. Mark was a California resident and performed all of his services in California from the grant date to the exercise date. On February 1, 2001, he permanently moved to Illinois. On June 1, 2001, he sold the stock at a gain.

### Determination:

Mark must make an AMT adjustment on his 2000 California return because he did not dispose of the stock in the year he exercised his option. The capital gain is not taxable by California in 2001 because Mark is a nonresident of California when he sold the stock.

### Disqualifying Disposition

If a taxpayer exercises an incentive stock option while a California resident or a nonresident and disposes of the stock in a disqualifying disposition while a nonresident, the transaction is treated as if the taxpayer exercised a nonstatutory stock option. The difference between the option price and the fair market value on the exercise date is wages. The source of the income is where the taxpayer performed services between the grant date and the exercise date. See Sun Microsystems, Inc., 69 TCM 1884 (1995). The source of the income is where the taxpayer performed services between the grant date and the exercise date.

No AMT adjustment is required if the taxpayer disposes of the stock in the same year he or she exercises the option. However, if the stock is disposed of in a later year, then an AMT adjustment must be made in the year the taxpayer exercised the incentive stock option. The source of the alternative minimum tax adjustment is determined in the same manner as is income from the exercise of a nonstatutory stock option for regular tax purposes.

### Example 4

Harry was a resident of California and worked for X Company. He performed all of his services in California during his entire career. On April 1, 1998, Harry was granted an option to purchase stock under his company’s incentive stock option plan. The option price on April 1, 1998, was $10 per share. On April 1, 2000, while still living and working in California, Harry exercised his option to purchase 30,000 shares of his company’s stock. The fair market value on April 1, 2000, was $50 per share. On July 1, 2000, Harry retired and permanently moved to Florida. On October 15, 2000, he sold the 30,000 shares for $35 per share.

**Determination:**

The character of the income from the disqualifying disposition is wages. Because Harry performed all of his services in California between the grant date and the option exercise date, 100 percent of the income will be wages from a California source.

| | | |
|---|---|---|
| FMV of stock, date of sale: | $ 1,050,000 | (30,000 shares @ $35* per share) |
| Less option price, date of grant: | - 300,000 | (30,000 shares @ $10 per share) |
| Wage income, CA source: | $ 750,000 | |

*The sale price of $35 is used to compute wage income because it is less than the exercise price of $50. There was no increase in the share's fair market value from the exercise date to the sale date, thus there is no capital gain.

Harry does not need to make an AMT adjustment in tax year 2000 because he disposed of the stock in the same year he exercised his option.

**Example 5**

Assume the same facts as the previous example, except Harry sold the stock on March 15, 2001, when the fair market value of the stock was $60 per share.

**Determination:**

**Tax Year 2000**

Harry must make an alternative minimum tax adjustment in tax year 2000 because he did not dispose of the stock in the same year he exercised his option. Because he performed 100 percent of his services in California, 100 percent of the AMT adjustment will have a California source. The adjustment is determined as follows:

| | | |
|---|---|---|
| FMV of stock, date of exercise: | $ 1,500,000 | (30,000 shares @ $50 per share) |
| Less option price: | - 300,000 | (30,000 shares @ $10 per share) |
| AMT adjustment, CA source: | $ 1,200,000 | |

Harry's AMT basis in the stock is determined as follows:

| | |
|---|---|
| Option price: | $ 300,000 |
| Plus AMT adjustment: | 1,200,000 |
| AMT basis: | $ 1,500,000 |

**Tax Year 2001**

Wage income from a California source is determined as follows:

| | | |
|---|---|---|
| FMV of stock, date of exercise: | $ 1,500,000 | (30,000 shares @ $50 per share) |
| Less option price: | - 300,000 | (30,000 shares @ $10 per share) |
| Wage income, CA source income: | $ 1,200,000 | |

The increase in the fair market value of the stock from the exercise price of $50 to the sale price of $60 is characterized as capital gain. The capital gain has a source in Florida, Harry's state of residence when he sold the stock.

| | | |
|---|---|---|
| FMV of stock, date of sale: | $ 1,800,000 | (30,000 shares @ $60 per share) |
| Less FMV of stock, date of exercise: | -1,500,000 | (30,000 shares @ $50 per share) |
| Capital gain, FL source income: | $ 300,000 | |

Harry may be allowed an AMT tax credit for prior year AMT.

## 3540 Employee Stock Purchase Plans

Internal Revenue Code Section 423 provides for the tax deferral of income from the grant or exercise of an option under an employee stock purchase plan. Income is recognized when the stock is sold.

If a taxpayer pays taxes to California and another state on any ordinary income recognized when the stock is sold, the taxpayer may be allowed an Other State Tax Credit on this double-taxed income. See RSTM 3900.

### Qualifying Disposition

A qualifying disposition occurs when the holding period requirements under IRC Section 423 are met.

If the option is granted to the taxpayer at a discount and the taxpayer sells the stock in a transaction satisfying the holding period requirements, the gain is ordinary income (wages) up to the amount by which the stock's fair market value on the date the option was granted exceeded the option price. Any excess gain is capital gain. If there is a loss from the sale, it is a capital loss, and there is no ordinary income.

### Disqualifying Disposition

A disqualifying disposition results when the taxpayer sells the stock without meeting the holding period requirements. The ordinary income is the amount by which the stock's fair market value of the stock on the exercise date exceeded the option price. The basis in the stock is increased by the amount of this ordinary income. The difference between the increased basis and the selling price of the stock is a capital gain or loss.

### California Resident on Date of Stock Sale

### Qualifying or Disqualifying Disposition

If a taxpayer exercises an option under an employee stock purchase plan while a nonresident and later sells the stock in a qualifying or disqualifying disposition while a California resident, the resulting ordinary income and capital gain are taxable by California because the taxpayer is a California resident when the stock is sold.

### Example 1

On March 1, 1998, while a resident of Massachusetts, Sam's employer granted him options at a discount under the company's stock purchase plan. On March 1, 2000, Sam exercised his options. On December 1, 2000, Sam permanently moved to California and on April 1, 2001, he sold the options at a gain.

**Determination:**

The resulting ordinary income and capital gain are taxable by California because Sam was a California resident when he sold the stock. If he also paid tax to Massachusetts, Sam is allowed an Other State Tax Credit against California taxes for taxes paid to Massachusetts on the double-taxed ordinary income.

**<u>Nonresident of California on Date of Stock Sale</u>**

### Qualifying or Disqualifying Disposition

If a taxpayer exercises an option under an employee stock purchase plan while a resident and later sells the stock in a qualifying or disqualifying disposition while a nonresident, the resulting ordinary income is taxable by California to the extent the taxpayer performed services in California from the grant date to the exercise date. Any capital gain has a source in the taxpayer's state of residence at the time the stock is sold.

**Example 2**

On February 1, 1998, Michelle's employer granted options to her under the company's employee stock purchase plan. On February 1, 2000, Michelle exercised these options. From the grant date to the exercise date, Michelle was a California resident and performed 50 percent of her services in California. On June 1, 2000, she permanently moved to Nevada and on January 15, 2001, she sold the stock at a gain.

**Determination:**

Because Michelle sold the stock before meeting the one-year holding period requirement, the difference between the fair market value of the stock on the date of exercise and the option price is taxable as wages. Since she performed 50 percent of her services in California from the grant date to the exercise date, 50 percent of the wage income is taxable by California. Any capital gain resulting from the increase in value over the fair market value on the date of exercise would have a source in Nevada, Michelle's state of residence when she sold the stock.

## 3550 California Qualified Stock Options

R&TC Section 17502 provides that a stock option specifically designated as a California qualified stock option will receive the favorable tax treatment applicable to incentive stock options and employee stock purchase plans. In order to receive this treatment, the following conditions must be met:

1. The option is issued after January 1, 1997, and before January 1, 2002.
2. The earned income of the employee from the corporation granting the option for the taxable year in which that option is exercised does not exceed $40,000.
3. The number of shares of stock granted under the option does not exceed $1,000, and the value of the shares does not exceed $100,000.
4. The employee must be employed by the company at the time the option is granted or must have been employed within three months (one year if permanently disabled) of the date the option is granted.

**If the provisions of R&TC Section 17502 are met**, federal law treats a California qualified stock option as a nonstatutory stock option. For federal tax purposes, taxable wage income is recognized upon the exercise of a California qualified stock option. A taxpayer should make an adjustment to federal adjusted gross income on Schedule CA (540) or Schedule CA (540NR) for the California qualified stock option wage income included on the federal return.

In the year, the stock is sold any capital gain or loss differences should be reported on California Schedule D.

See RSTM 3530, Incentive Stock Options, to determine the California taxation of these options if there is a change in the taxpayer's residency.

**If the provisions of R&TC Section 17502 are not met,** the stock option is treated as a nonstatutory stock option. See RSTM 3520, Nonstatutory Stock Options, to determine the California taxation of these options if there is a change in the taxpayer's residency.

## 3560 Stock Options Summary Table

| Type of stock option | California residents | California nonresidents |
|---|---|---|
| **Nonstatutory stock option (NSO)** | **on the date of NSO exercise:**<br>• California taxes the wage income.<br>• Possible other state tax credit. | **on the date of NSO exercise NSO:**<br>• California taxes the wage income to the extent services were performed in California from the grant date to the exercise date.<br>• Possible other state tax credit. |
| | **on the date of stock sale**:<br>• California taxes the capital gain. | **on the date of stock sale:**<br>• California does not tax the capital gain. |
| **Incentive stock option (ISO)** | **on the date of ISO exercise:**<br>• If the stock is not sold in the year of exercise, make AMT adjustment.<br>• Increase AMT basis by the AMT adjustment. | **on the date of ISO exercise:**<br>• If the stock is not sold in the year of exercise, make AMT adjustment.<br>• Include AMT adjustment to the extent services were performed in California from the grant date to the exercise date.<br>• Increase AMT basis by the AMT adjustment. |

| | | |
|---|---|---|
| | **on the date the stock is sold in a qualifying disposition at a gain:**<br>• California taxes the capital gain.<br>• Possible AMT credit. | **on the date the stock is sold in a qualifying disposition at a gain:**<br>• California does not tax the capital gain.<br>• Possible AMT credit. |
| | **on the date the stock is sold in a disqualifying disposition:**<br>• California taxes the wage income and capital gain (if any).<br>• Possible other state tax credit.<br>• Possible AMT credit. | **on the date the stock is sold in a disqualifying disposition:**<br>• California taxes the wage income to the extent services were performed in California from the grant date to the exercise date.<br>• California does not tax the capital gain (if any).<br>• Possible other state tax credit.<br>• Possible AMT Credit. |
| **Employee stock purchase plans (ESPP)** | **on the date the stock is sold in a qualifying or disqualifying disposition at a gain:**<br>• California taxes the ordinary income and capital gain.<br>• Possible other state tax credit. | **on the date the stock is sold in a qualifying or disqualifying disposition at a gain:**<br>• California taxes the ordinary income to the extent services were performed in California from the grant date to the exercise date.<br>• California does not tax the capital gain (if any).<br>• Possible other state tax credit. |
| **California qualified stock options (CQSO)** | **and R&TC Section 17502 provisions are met:**<br>• Same tax treatment as ISO. | **and R&TC Section 17502 provisions are met:**<br>• Same tax treatment as ISO. |
| | **and R&TC Section 17502 provisions are not met:**<br>• Same tax treatment as NSO. | **and R&TC Section 17502 provisions are not met:**<br>• Same tax treatment as NSO. |

## 3600 QUALIFIED PENSION, PROFIT SHARING, AND STOCK BONUS PLANS

### Change of Residency to California (Move-in)

If a taxpayer is a California resident when qualified pension, profit sharing, or stock bonus plan income is received, the income is taxable by California.

**Example 1**

Jim, a California resident, received pension income during 2002 through a qualified plan from his former Nevada employer. The pension relates to services he performed as an equipment operator in Nevada.

**Determination:**

Jim's qualified pension income is taxable to California because he was a California resident when he received the income.

### Change of Residency from California (Move-out)

R&TC Section 17952.5(a) states:

Gross income of a nonresident, as defined in 17015, from sources within this state shall **not** include “qualified retirement income” received on or after January 1, 1996, for any part of the taxable year during which the taxpayer was not a resident. Refer to R&TC Section 17952.5(b) for the income included as “qualified retirement income” California does not tax the qualified retirement income received by nonresidents on or after January 1, 1996, even if the taxpayer performed the services that gave rise to the income in California.

**Example 3**

Laura is a nonresident of California. During 2001, she received qualified pension income, which she earned by performing services in California from 1990 through 1999.

**Determination:**

Because Laura is a nonresident of California; the qualified pension income received in 2001 does not have a California source and is not taxable by California.

## 3610 INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)

### Nonresidents

California does not tax the IRA distributions of a nonresident.

### Change of Residency to California (Move-in)

Taxpayers are treated as though they were California residents for all prior years for all items of deferred income, which includes individual retirement accounts (IRAs). Accordingly, a taxpayer will be allowed a basis for contributions that were actually made, which would not have been allowed under California law had the taxpayer been a California resident.

California did not conform to the $2,000 or 100 percent of compensation annual contribution limit permitted under federal law from 1982 through 1986. During these years, California limited the deduction to the lesser of 15 percent of compensation, or $1,500, and denied a deduction altogether to individuals who were active participants in qualified or government plans. Any amounts an individual contributed in excess of California deduction limits during these years create a basis in the IRA.

**Example 1**

Janet became a California resident on January 1, 2001. The fair market value of her IRA on January 1, 2001, was $9,000. Janet received IRA distributions of $1,500 in 2001. Janet's contributions in excess of California deduction limits during 1982-1986 were $2,500. She received IRA distributions of $3,000 in 2002.

**Determination:**

**Taxable year 2002**

| | | | |
|---|---|---|---|
| IRA distribution, 2002 | | | $3,000 |
| Less: | California IRA basis | | |
| | Contributions in excess of California deduction limits | $2,500 | |
| Less: | California IRA basis recovered in 2001 | 1,500 | |
| | California IRA basis available in 2002 | | 1,000 |
| Taxable IRA income | | | $2,000 |

## 3700 INSTALLMENT SALES

### Always a Nonresident

California taxes the installment proceeds received by a nonresident to the extent the income from the sale was from a California source. California taxes real property based upon where the property is located.

**Example 1**

Ken has always been a nonresident of California. On March 1, 2001, he sold a California rental property in an installment sale. During 2001 and 2002, he received installment proceeds comprised of capital gain income and interest income.

**Determination:**

The capital gain income is taxable by California in both 2001 and 2002 because the property was located in California. The interest income is not taxable by California and has a source in Ken's state of residence.

### Change of Residency to California (Move-in)

If a taxpayer is a California resident who sold property located outside California on the installment basis while a nonresident, the installment proceeds the taxpayer receives while a California resident are taxable by California.

**Example 2**

On July 1, 2001, while a nonresident of California, Tim sold a Texas rental property in an installment sale. On May 15, 2002, he became a California resident and on August 1, 2002, he received installment proceeds comprised of capital gain income and interest income.

**Determination:**

Tim's capital gain income and interest income received on August 1, 2002, are taxable by California because Tim was a California resident when he received the proceeds.

**Example 3**

On September 1, 2000, while a nonresident of California, Bob sold stock (intangible property) in an installment sale. On June 1, 2002, he became a California resident. On October 1, 2002, he received installment proceeds comprised of capital gain income and interest income.

**Determination:**

Bob's capital gain income and interest income received on October 1, 2002, are taxable by California because he was a California resident when he received the proceeds.

**Change of Residency from California (Move-out)**

If a taxpayer is a former California resident, the installment proceeds received from the sale of property located outside California that the taxpayer sold while a California resident are not taxable by California.

**Example 4**

In June 1999, while a California resident, Beth sold a parcel of real property located in Washington in an installment sale. On March 1, 2002, she became an Ohio resident. On June 1, 2002, she received installment proceeds comprised of capital gain income and interest income.

**Determination:**

The capital gain income is not taxable by California because the property was not located in California. The interest income is not taxable by California because Beth was a nonresident of California when she received the proceeds.

**Example 5**

In March 2000, while a California resident, Rick sold a parcel of real property located in California in an installment sale. On June 1, 2002, he became a Washington resident. On August 1, 2002, he received installment proceeds comprised of capital gain income and interest income.

**Determination:**

The capital gain income is taxable by California because the property Rick sold was located in California. The interest income is not taxable by California because Rick was a nonresident of California when he received the proceeds.

CCR Regulations Section 17952(d) provides that the source of gains and losses from the sale or other disposition of intangible personal property is determined at the time of the sale or disposition of that property. For example, if a California resident sells intangible personal property under the installment method, and subsequently becomes a nonresident, any later recognized gain attributable to any installment payment receipts relating to that sale will be sourced to California (absent a business situs exception). Further, a California nonresident who sells intangible personal property would be taxed by California on gain as it is recognized upon receipt of future installment payments if the intangible personal property had a business situs in California at the time of the sale.

**Example 6**

In September 1999, while a California resident, Alan sold stock (intangible property) in an installment sale. On February 1, 2002, he became a Florida resident, and on May 1, 2002, he received installment proceeds comprised of capital gain income and interest income.

**Determination:**

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

## 3710 ESTATES AND TRUSTS

R&TC Section 17953 states that income of estates and trusts distributed or distributable to nonresident beneficiaries is income from California sources only if the income of the estate or trust is derived from California sources. The determination of whether or not income generated from a California estate or trust is taxable to a nonresident is to be made in the same manner as it would be for the decedent or grantor. See the Appeal of Estate of Marilyn Monroe, Deceased, 1975-SBE-032, April 22, 1975.

R&TC Section 17953 also provides that nonresident beneficiaries shall be deemed to be the owner of intangible property owned by the estate or trust. Therefore, under the mobilia doctrine, the income from such property is excluded from California source income unless the property acquires a business situs in California.

## 3720 TAX TREATIES WITH FOREIGN COUNTRIES

United States tax treaties with foreign countries generally have no application to California tax determination. Income that is excluded for federal tax purposes under a federal tax treaty is not excluded for California income tax purposes. Most federal tax treaties specifically exclude application to state income taxes. However, if the treaty specifically states that it includes application to California taxes, we must follow the terms of the treaty. See Audit Program Report 84-8, September 18, 1984.

## 3730 COVENANT NOT TO COMPETE

R&TC Section 17954 authorizes us to prescribe rules and regulations for allocating and apportioning income from sources within and without California.

CCR Regulations Section 17951-6, Income from a Covenant Not to Compete, became operative as of January 23, 2002, and is applicable to all open taxable years.

A covenant not to compete includes any arrangement to refrain from engaging in an activity, directly or indirectly, similar to the business activity carried on by the business that was sold. This definition includes, but is not limited to, covenants not to create or acquire an interest in a competitor, covenants not to solicit employees, and covenants not to disclose proprietary information (CCR Section 17951-6(a)(4)).

The sale of a business includes all of the following (CCR Section17951-6(a)(5)):

The sale or disposition of the goodwill of a sole proprietorship, partnership, limited liability company, S corporation, or C corporation.

A. The sale or disposition of substantially all of the assets, together with the goodwill, of a sole proprietorship, partnership, limited liability company, S corporation, or C corporation.

B. The sale or disposition of substantially all of an individual's interest in a sole proprietorship, partnership, limited liability company, S corporation, or C corporation, including but not limited to:

   1. The sale or disposition by a shareholder of substantially all of its shares in the corporation.
   2. The sale or disposition by a partner of substantially all of its interest in a partnership.

Payments received for a covenant not to compete are taxable as ordinary income. See John D. Beals v. Commissioner, 36-1 USTC 9917 (1936).

CCR Section17951-6(a) provides that income from a covenant not to compete executed in connection with the sale of a business conducted entirely within or both within and without California has a source in California to the extent the income is assigned to California by this regulation.

**Identifying the Legally Enforceable Area:**

Income from a covenant not to compete is assigned to California by first identifying the legally enforceable area within which the promisor forfeits the right to act (CCR Section 17951-6(a) (1)). Business and Professions Code Sections 16600 and 16601 recognize that covenants not to compete are valid only if they are executed in connection with the sale of a business or its goodwill and only to areas where business was carried on. Courts interpreting Business and Professions Code Section 16601 have limited the area of prohibition to places where business was carried on in substantial amounts. See Kaplan v. Nalpak Corporation, 158 Cal. App. 2d 197 (1958). Courts seem unwilling to void covenants not to compete. However, courts reform covenants that are overly broad in geographic scope to comply with the limits imposed by law. See Swenson v. File, 3 Cal. App. 3d 389 (1970).

A contract of sale containing a covenant not to compete that includes more territory than allowed by law or fails to limit the territory at all is valid only within the area wherein the business is located. See Legal Ruling 084, the Appeal of James B. and Linda Pesiri, 1989-SBE-027, September 26, 1989; and the Appeal of AlDean and Clara Washburn, 1982-SBE-140, June 29, 1982.

**Note:** If the covenant not to compete agreement is not governed under California law, we must review the enforceability of the agreement in its governing state.

**Income Assignment**

After identifying the legally enforceable area of abstinence, we then assign the income to locations within this area according to the average of the apportionment factors (property, payroll, and sales) of the business in accordance with R&TC Section 25128(a). (CCR Section 17951-6(a) (1)).

For taxable years of sale occurring on or after January 1, 1993, R&TC Section 25128(a) allows for a double-weighted sales factor and a denominator of four (four-factor formula). Prior to January 1, 1993, we weighted property, payroll, and sales equally (three-factor formula).

We must use the apportionment factors of the business that was sold for the year in which the sale occurred in all but unusual circumstances (CCR Section17951-6(a) (6)).

**The factors are computed as follows:**

**Property Factor**

<u>Property included in the denominator which is assigned to California</u>

Property assigned to the legally enforceable area

**Payroll Factor**

<u>Payroll included in the denominator which is assigned to California</u>

Payroll assigned to the legally enforceable area

**Sales Factor**

<u>Sales included in the denominator which is assigned to California</u>

Sales assigned to the legally enforceable area

For purposes of computing the sales factor, assign all sales of tangible personal property to the state of the purchaser where the property is delivered or shipped. The provisions of R&TC Section 25135(b), relating to throwback sales, shall not apply (CCR Section 17951-6(a) (3)).

Public Law (PL) 86-272 forbids states from imposing an income tax on income derived within a state from interstate commerce if the **only** business activity within the state is the "solicitation of orders" for sales of tangible personal property. The orders must be sent out of the state for approval or rejection and, if approved, must be filled by shipment or delivery from a point outside the state. If sales are immune from taxation in a state by reason of PL 86-272, they are subject to throwback provisions.

You should assign any throwback sales included in the California sales factor to the state of destination only if that state is included in the legally enforceable area of abstinence. Such areas include only those in which the corporation conducted business in substantial amounts. (Kaplan v. Nalpak, supra.) If throwback sales were made to states where the corporation did not conduct sufficient activity to include that state in the enforceable area of abstinence, the throwback sales must reduce both the numerator and denominator of the California sales factor, and not simply reduce the California percentage.

**Exception to the use of apportionment factors of the business for the year of sale:**

If using the apportionment factors of the business for the year of sale does not fairly reflect the nature of prohibited activities expressed or reasonably implied by the covenant not to compete, or does not accurately represent the location of recent historical business activities of the business sold, such that there is a gross distortion of income assigned within the legally enforceable area, the Franchise Tax Board may require, or the promisor may petition the Franchise Tax Board for (CCR Section 17951-6(a)(6)):

(A) The use of factors of the business which was sold for another year or combination of years; or

(B) The employment of another method of assigned income; provided the use of another year or another method produces a fair and equitable assignment of income within the legally enforceable area.

## 3740 ROYALTIES AND RESIDUALS

Generally, there are two types of royalties and residuals:

- Income received for the performance of personal services.
- Income received from the sale of rights to an independently developed finished product.

The landmark case for treating royalties as compensation for personal services having a source where the services were performed is Ingram v. Bowers 47F (2d) 925 D.C.S.D.N.Y. 1931, aff'd 57 F (2d) 65 CCA 2nd 1932. The issue involved in the case was whether the federal government had a right to tax income received as royalties by Enrico Caruso. Mr. Caruso, a famous Italian opera singer, was a nonresident alien. The royalties were received for records that were recorded in the U.S. and sold throughout the world. The courts held that Mr. Caruso had no right or interest in the records since they were the property of the recording company. The royalties he received were for performing services (i.e., recording records) in the U.S.

Do not confuse this type of income with true royalties such as those received by the author of a book or inventor of an invention for which he or she has a copyright or patent. Copyrights and patents are considered intangible assets. In such cases, the situs would generally be the state of residence of the author or inventor. See RSTM 3350 for more information concerning intangible assets.

The type of payment involved in the Caruso case was not related to a patent or copyright but was merely a payment for personal services measured by a percentage of future sales. The same rationale applies to motion picture and television residuals. The Appeal of Estate of Marilyn Monroe, Deceased, 1975-SBE-032, April 22, 1975, provided that California can continue to tax California source income after the death of the person who originally rendered the personal services.

# 3800 ALIMONY

### Residents

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.

### Nonresidents

Alimony received by a nonresident is not taxable by California. See Francis v. McColgan, Cal. Crt. of App., (1951).

**For taxable years beginning prior to January 1, 2004:**

Alimony paid by a nonresident, even if paid to a nonresident, is not deductible. See R&TC Section 17302, effective before February 11, 2004, and the Appeal of William M. and Shirley D. Langston, 1983-SBE-010, January 3, 1983.

**For taxable years beginning on or after January 1, 2004:**

Alimony paid by a nonresident is allowed in the same ratio (not to exceed 1.00) that California adjusted gross income, computed without regard to the alimony deduction, bears to total adjusted gross income, computed without regard to the alimony deduction. See R&TC Section 17302, effective February 11, 2004.

### Example 1

Jeffrey, a Wyoming resident, paid $12,000 in alimony during 2004. He owns rental properties in California and reports rental income of $24,000 as his only California source income on Form 540NR. Jeffrey's total adjusted gross income (without regard to the alimony deduction) is $240,000.

**Determination:** Jeffrey computes his alimony deduction as follows:

| | | |
|---|---|---|
| Alimony paid: | | $12,000 |
| California AGI* | $ 24,000 | |
| Total AGI* | $240,000 | X 10% |
| Alimony deduction: | | $ 1,200 |

* Without regard to the alimony deduction

### Part-Year Residents

California taxes alimony received during the period of residency. California does not tax alimony received during the period of nonresidency.

- **For taxable years beginning prior to January 1, 2004**

Alimony paid during the period of residency is deductible and alimony paid during the period of nonresidency is not deductible.

- **For taxable years beginning on or after January 1, 2004**

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 adjusted gross income, computed without regard to the alimony deduction, bears to total adjusted gross income, computed without regard to the alimony deduction.

**Example 2**

During 2004, Helen, a part-year resident, made alimony payments totaling $8,400 while she lived in California and alimony payments totaling $6,000 after she permanently moved to New York. Helen's California AGI (without regard to the alimony deduction) is $100,000 and her total AGI (without regard to the alimony deduction) is $400,000.

**Determination:**

Helen computes her alimony deduction as follows:

| | | | |
|---|---|---|---|
| Alimony paid during residency period | | | $8,400 |
| Alimony paid during nonresidency period | | $6,000 | |
| California AGI* | $100,000 | | |
| Total AGI* | $400,000 | X 25% | |
| Alimony deduction allowed for nonresidency period | | | 1,500 |
| Total alimony deduction | | | $9,900 |

* Without regard to the alimony deduction

## 3810 DEDUCTIONS

R&TC Section 17301 requires that we apportion and allocate deductions related to income from sources within and without California under our rules and regulations.

The federal foreign income exclusion, foreign tax deduction, and foreign earned income credit are not applicable to California.

**Itemized or Standard Deductions - Nonresidents and Part-Year Residents**

Compute itemized or standard deductions allowed by California by applying the ratio of California adjusted gross income to total adjusted gross income to **all** itemized or standard deductions allowed to California residents.

## 3820 NET OPERATING LOSSES

We allow a net operating loss (NOL) deduction under R&TC Section 17201 and R&TC Section 17276, which conform to Internal Revenue Code Section 172.

For taxable years beginning in 2002, a taxpayer can take a California net operating loss deduction for California source purposes without having to have a net operating loss from all sources.

R&TC Section 17041(i)(2) is amended to provide that for purposes of computing "taxable income of a nonresident or part-year resident," the amount of any net operating loss sustained in any taxable year during any part of which the taxpayer was not a resident of this state shall be limited to the sum of the following:

(A) The amount of the loss attributable to the part of the taxable year in which the taxpayer was a resident.

(B) The amount of the loss which, during the part of the taxable year the taxpayer is not a resident, is attributable to California source income and deduction allowable in arriving at taxable income of a nonresident or part-year resident.

**Note:** The NOL deduction for net operating loss carryovers was suspended for the 2002 and 2003 taxable years.

**Always a Nonresident**

For taxable years beginning in 2002, a taxpayer is allowed a net operating loss deduction carryover to 2004 for California taxable income based upon California sourced income and deductions, regardless of whether the taxpayer has an NOL in computing total taxable income.

**Example 1**

David is a resident of Nevada and operates two businesses. One business is conducted wholly within California and the other business is conducted wholly within Nevada.

In 2002, David's businesses produced the following results:

| Taxable year 2002 | Total taxable income | CA taxable income |
|---|---|---|
| NV business | $ 9,000 | |
| CA business | (3,000) | $ (3,000) |
| Total | $ 6,000 | $ (3,000) |

**Determination:**

Consider only David's California sourced income and losses when determining if he has a California NOL. For 2002, David has a California NOL of $3,000. He may carry forward $1,800 (60 percent of the $3,000 NOL), to 2004 to offset California taxable income.

**Change of Residency to California (Move-in)**

For taxable years beginning in 2002, if a taxpayer has NOL carryovers and was a nonresident of California in prior years, the NOL carryovers need to be restated as if the taxpayer had been a California resident for all prior years.

**Example 2**

Greta moved to California on January 1, 2002. In 2001, she operated a business located in Texas and incurred an NOL carryover based on California law of $6,000 from this business. In 2002, Greta incurred a $3,000 loss from her California business and she earned income of $1,000 from her Texas business.

**Determination:**

**Step 1**

Restate Greta's 2001 NOL carryover as if she had been a California resident for 2001.

**2001 Restatement**

| | |
|---|---|
| NOL carryover | $ (6,000) |
| CA NOL allowed percentage, 2001 | x 55% |
| NOL carryover to 2002 | $ (3,300) |

**Step 2**

Net Greta's 2002 business income and losses to determine the amount of her NOL to carry forward to 2004.

| **Taxable year 2002** | **Total taxable income** |
|---|---|
| TX business income | $ 1,000 |
| CA business loss | (3,000) |
| Total | $ (2,000) |
| CA NOL allowed percentage, 2002 | x 60% |
| NOL, 2002 | $ (1,200) |
| Prior year NOL carryover | (3,300) |
| NOL carryover to 2004 | $ (4,500) |

**Change of Residency from California (Move-out)**

For taxable years beginning in 2002, if a taxpayer has NOL carryovers and becomes a nonresident of California, the taxpayer's NOL carryovers need to be restated as if the taxpayer had been a nonresident of California for all prior years.

**Example 3**

Assume the same facts as Example 2. Greta's Texas and California businesses earned income in 2003. On January 1, 2004, Greta becomes a nonresident of California. In 2004, Greta's Texas and California businesses earn income of $5,000 and $4,000, respectively.

**Step 1**

Restate Greta's NOL carryovers as if she had been a nonresident of California for all prior years by netting business income and losses from California sources only.

| **2001 Restatement** | **Total taxable income** | **CA taxable income** |
|---|---|---|
| Texas source business loss | $(6,000) | |
| CA NOL allowed percentage, 2001 | x 55% | |
| NOL carryover to 2002 | $(3,300) | $ 0 |

| **2002 Restatement** | **Total taxable income** | **CA taxable income** |
|---|---|---|
| TX business income | $ 1,000 | |
| CA business loss | (3,000) | $ (3,000) |
| Total | $ (2,000) | $ (3,000) |
| CA NOL allowed percentage, 2002 | x 60% | x 60% |
| NOL, 2002 | $ (1,200) | $ (1,800) |
| Prior year NOL carryover | (3,300) | |
| NOL carryover to 2004 | $ (4,500) | $ (1,800) |

**Part-Year Resident**

If a taxpayer changed residency during 2004, compute the NOL deduction using resident rules for the period of the year the taxpayer was a California resident and nonresident rules for the period of the year the taxpayer was a nonresident. Compute any NOL carryovers as if the taxpayer were a California resident for all prior years **and** as if the taxpayer were a nonresident for all prior years. Prorate both NOL carryover amounts based upon the period of California residency and the period of nonresidency during the year.

**Example 4**

Henry moved to California on May 1, 2004. His total and California source income and losses from his business operations for 2004 were as follows:

| **Before May 1, 2004** | | **After May 1, 2004** | |
|---|---|---|---|
| Total business income | $ 12,000 | Total business losses | $ (16,000) |
| CA business losses | (2,000) | CA business income | 10,000 |

Henry's NOL carryover from 2003 was $6,000, restated as if he had been a California resident for all prior years, and $3,000, restated as if he had been a nonresident for all prior years.

**Determination:**

**Step 1**

Compute Henry's current year NOL by netting his total business income and losses for his period of residency and his California source business income and losses for the period of his nonresidency:

| | |
|---|---|
| CA business losses, before May 1, 2004 | $(2,000) |
| Total business losses, after May 1, 2004 | (16,000) |
| Total | $(18,000) |
| CA NOL allowed percentage, 2004 | X 100% |
| Current year NOL, 2004 | $(18,000) |

**Step 2**

Prorate Henry's NOL carryover amounts based upon periods of California residency and nonresidency during 2004.

| **Period of Residency** | | **Period of Nonresidency** | |
|---|---|---|---|
| NOL carryover, as if a CA resident for all prior years | $ (6,000) | NOL carryover, as if a nonresident for all prior years | $ (3,000) |
| **CA resident days** ÷ total days 245 ÷ 366 | X .6694 | **Nonresident days** ÷ total days 121 ÷ 366 | X .3306 |
| Prorated NOL carryover | $ (4,016) | Prorated NOL carryover | $ (992) |

**Step 3**

Compute Henry's prior year NOL carryover:

| | |
|---|---|
| NOL carryover from 2003, resident period | $( 4,016) |
| NOL carryover from 2003, nonresident period | $ ( 992) |
| Total NOL carryover from 2003 | $ ( 5,008) |

## 3830 ALTERNATIVE MINIMUM TAX

Alternative minimum tax is permitted under R&TC Section 17062, which conforms to Internal Revenue Code Section 55 – Internal Revenue Code Section 59.

The **California alternative minimum tax** of a nonresident or part-year resident is the amount by which the California tentative minimum tax exceeds the prorated regular tax. The computation is:

CA alternative minimum tax = CA tentative minimum tax – Prorated regular tax

The **California tentative minimum tax** is the California alternative minimum taxable income multiplied by a rate. The rate is the amount of tax on total tentative minimum tax divided by the total alternative minimum taxable income. The computation is:

$$\text{California tentative minimum tax} = \text{California alternative minimum taxable income} \times \frac{\text{Total tentative minimum tax}}{\text{Total alternative minimum taxable income}}$$

The **California alternative minimum taxable income** is the combined total of:

- The alternative minimum taxable income derived from California sources for any part of the taxable year the taxpayer was a nonresident.
- The alternative minimum taxable income from all sources for any part of the taxable year the taxpayer was a resident.

For the period of nonresidency, include or allow any carryovers, deferred income, suspended losses, or suspended deductions only to the extent they were derived from California sources.

The **total alternative minimum taxable income** is the alternative minimum taxable income determined as if the nonresident or part-year resident were a California resident in both of the following:

- Current year.
- All prior years for any carryovers, deferred income, suspended losses, or suspended deductions.

**Total tentative minimum tax** is the tax on the total alternative minimum tax income.

The following example shows how the calculation works:

**Example 1**

Susan and her spouse moved to California and became residents on May 1, 2002. Combined wages for the year totaled $170,000. Susan received $100,000 after her move to California. On October 1, 2002, Susan exercised an incentive stock option valued at $90,000, for which she paid $10,000 (preference amount $80,000). The total taxable income for the year was $150,000, with $20,000 in itemized deductions. Five thousand dollars ($5,000) of the itemized deductions were real and personal property taxes, which are preference items. The prorated regular tax was $6,000.

**Determination:**

**Total alternative minimum taxable income**

| | | |
|---|---|---|
| Real and personal property tax preference | | 5,000 |
| Plus: Incentive stock option preference | | + 80,000 |
| Plus: Total taxable income | | +150,000 |
| Total alternative minimum taxable income | | 235,000 |
| **Total tentative minimum tax** | | |
| Total alternative minimum taxable income | | 235,000 |
| Less: Exemption amount | | - 65,114 |
| | | 169,886 |
| Alternative minimum tax rate | | x .07 |
| Total tentative minimum tax | | 11,892 |
| **California alternative minimum tax adjusted gross income** | | |
| California (regular tax) adjusted gross income | | 100,000 |
| Plus: Incentive stock option preference amount | | + 80,000 |
| California alternative minimum tax adjusted gross income | | **180,000** |
| **Total alternative minimum tax adjusted gross income** | | |
| Total alternative minimum taxable income | | 235,000 |
| Total itemized deductions | 20,000 | |
| Less: Real and personal property tax preference | - 5,000 | |
| Total alternative minimum tax itemized deductions | | + 15,000 |
| Total alternative minimum tax adjusted gross income | | **250,000** |
| **California alternative minimum taxable income** | | |
| Total alternative minimum tax itemized deductions | 15,000 | |
| Multiply by the ratio: | | |
| CA alternative minimum tax adjusted gross income 180,000 / Total alternative minimum tax adjusted gross income 250,000 = | x .7200 | |
| Prorated alternative minimum tax itemized deductions | | - 10,800 |
| California alternative minimum taxable income | | **169,200** |
| **California alternative minimum tax** | | |
| California alternative minimum taxable income | | 169,200 |
| Multiply by the ratio: | | |
| Total tentative minimum tax (11,892) / Total alternative minimum taxable income (235,000) = | | x .0506 |
| California tentative minimum taxable income | | 8,561 |
| Less: Prorated regular tax | | - 6,000 |

| | |
|---|---|
| California alternative minimum tax | **2,561** |

## 3840 PASSIVE ACTIVITY LOSSES

We allow a passive activity loss deduction under R&TC Section 17551, which conforms to Internal Revenue Code Section 469. Effective January 1, 1987, individuals can only offset losses from passive activities with income from passive activities. Taxpayers can carry forward disallowed losses and credits can be carried forward to subsequent years and use them to offset income from passive activities for those years.

**Always a Nonresident**

If a taxpayer has always been a nonresident of California, determine the allowed passive activity losses and suspended losses based only upon California source passive income and loss items to compute California taxable income. Nonresidents can carry forward only California source passive losses into the following year.

**Example 1**

Gary has always been a resident of Texas. Prior to 2002, he was not engaged in any passive activities. During 2002, Gary purchased rental properties in both California and Texas. In 2002, his California and non-California source passive income and losses included California rental income of $2,000, California rental losses of $30,000, and Texas rental income of $4,000.

**Determination:**

Based upon the netting of his passive income and losses and the allowance of up to $25,000 for rental losses, determine Gary's passive losses allowed in 2002 and suspended to 2003 as follows:

| **Taxable year 2002:** | **Total taxable income** | **CA taxable income** |
|---|---|---|
| CA rental income | $ 2,000 | $ 2,000 |
| CA rental losses | (30,000) | (30,000) |
| TX rental income | 4,000 | |
| Total | $ (24,000) | $(28,000) |
| Allowed rental losses | 24,000 | 25,000 |
| Suspended loss to 2003 | $ 0 | $ (3,000) |

**Example 2**

Peggy has always been a resident of New York. Prior to 2002, she was not engaged in any passive activities. During 2002, Peggy became engaged in California and non-California passive activities. In 2002, her passive income and losses included California source partnership income of $2,000, California source S corporation losses of $8,000, and New York partnership income of $3,000.

**Determination:**

Based upon the netting of her passive income and losses, determine Peggy's suspended losses to be carried forward to 2003 as follows:

| **Taxable year 2002** | **Total taxable income** | **CA taxable income** |
|---|---|---|
| CA partnership income | $ 2,000 | $ 2,000 |
| CA S-corporation loss | (8,000) | (8,000) |
| NY partnership income | 3,000 | |
| Suspended loss to 2003 | $ (3,000) | $(6,000) |

**Change of Residency to California (Move-in)**

For taxable years beginning in 2002, if a taxpayer had suspended passive losses and was a nonresident of California in prior years, the suspended passive losses need to be restated as if the taxpayer had been a California resident for all prior years.

**Example 3**

Assume the same facts as Example 2. On January 1, 2003, Peggy becomes a California resident. In 2003, her passive income and losses include California source partnership income of $3,000, California source S corporation losses of $1,000, and New York source partnership income of $7,000.

**Determination:**

**Step 1**

Restate Peggy's 2002 suspended passive loss as if she had been a California resident for 2002.

| **2002 Restatement:** | **Total taxable income** |
|---|---|
| CA partnership income | $ 2,000 |
| CA S corporation loss | (8,000) |
| NY partnership income | 3,000 |
| Suspended passive loss to 2003 | $ (3,000) |

**Step 2**

Net Peggy's passive income and losses to determine the amount of passive income to include in total taxable income.

| **Taxable year 2003** | **Total taxable income** |
|---|---|
| CA partnership income | $ 3,000 |
| CA S corporation loss | (1,000) |
| NY partnership income | 7,000 |
| Total | $ 9,000 |
| Suspended passive loss, 2002 | (3,000) |
| Passive income, 2003 | $ 6,000 |

**Change of Residency from California (Move-out)**

For taxable years beginning in 2002, if a taxpayer has suspended passive losses and becomes a nonresident of California, the taxpayer's suspended passive losses need to be restated as if the taxpayer had been a nonresident of California for all prior years.

**Example 4**

Assume the same facts as Examples 2 and 3. On January 1, 2004, Peggy becomes a nonresident of California again. During 2004, her passive income and losses include California source partnership income of $15,000, California source S corporation losses of $7,000, and New York source partnership income of $2,000.

**Determination:**

**Step 1**

Restate Peggy's suspended passive losses as if she had been a nonresident of California for all prior years by netting passive income and passive losses from California sources only.

| **2002 Restatement:** | **Total taxable income** | **CA taxable income** |
|---|---|---|
| CA partnership income | $ 2,000 | $ 2,000 |
| CA S corporation loss | (8,000) | (8,000) |
| NY partnership income | 3,000 | |
| Suspended passive loss to 2003 | $ (3,000) | $ (6,000) |

| **2003 Restatement:** | **Total taxable income** | **CA taxable income** |
|---|---|---|
| CA partnership income | $ 3,000 | . $ 3,000 |
| CA S corporation loss | (1,000) | (1,000) |
| NY partnership income | 7,000 | |
| Total | $ 9,000 | $ 2,000 |
| Suspended loss from 2002 | (3,000) | (6,000) |
| Income or suspended loss, 2003 | $ 6,000 | $ (4,000) |

**Step 2**

Net Peggy's passive income and losses to determine the amount of passive income to include in total taxable income and California taxable income.

| **Taxable year 2004:** | **Total taxable income** | **CA taxable income** |
|---|---|---|
| CA partnership income | $15,000 | $ 15,000 |
| CA S corporation loss | (7,000) | (7,000) |
| NY partnership income | 2,000 | |
| Total | $10,000 | $ 8,000 |
| Suspended loss from 2003 | 0 | (4,000) |
| Passive income, 2004 | $10,000 | $ 4,000 |

**Part-Year Resident**

If a taxpayer changed residency during a taxable year beginning on or after January 1, 2002, compute income and deductions using resident rules for the period of the year the taxpayer was a California resident and nonresident rules for the period of the year the taxpayer was a nonresident. Compute any suspended passive losses as if the taxpayer were a California resident for all prior years **and** as if the taxpayer were a nonresident for all prior years. Prorate both suspended passive loss amounts based upon the period of California residency and the period of nonresidency during the year.

**Example 5**

George became a nonresident of California on October 1, 2002. His passive activities did not include any rental properties. His total and California source passive income and losses for 2002 were as follows:

| **Before October 1, 2002** | | **After October 1, 2002** | |
|---|---|---|---|
| Total passive income | $ 13,500 | Total passive income | $ 4,500 |
| CA passive income | 7,500 | CA passive income | 2,500 |
| Total passive losses | (3,000) | Total passive losses | (1,000) |
| CA passive losses | (6,000) | CA passive losses | (2,000) |

George's suspended passive loss from 2001 was $7,000, restated as if he had been a California resident for all prior years, and $5,000, restated as if he had been a nonresident for all prior years.

**Determination:**

**Step 1**

Net George's total passive income and losses for the period of residency and his California source passive income and losses for the period of nonresidency.

| | |
|---|---|
| Total passive income, before October 1, 2002 | $13,500 |
| Total passive losses, before October 1, 2002 | (3,000) |
| CA passive income, after October 1, 2002 | 2,500 |
| CA passive losses, after October 1, 2002 | (2,000) |
| Passive income before suspended losses | $11,000 |

**Step 2**

Prorate George's suspended passive loss amounts based upon periods of California residency and nonresidency during 2002.

| **Period of Residency** | | **Period of Nonresidency** | |
|---|---|---|---|
| 2001 suspended loss, as if a CA resident for all prior years | $(7,000) | 2001 suspended loss, as if a nonresident for all prior years | $(5,000) |
| CA resident days ÷ total days (273 ÷ 365) | X .7479 | Nonresident days ÷ total days (92 ÷ 365) | X .2521 |
| Prorated 2001 suspended loss | $(5,235) | Prorated 2001 suspended loss | $(1,260) |

**Step 3**

Compute George's passive income or suspended loss for taxable year 2002.

| **Taxable year 2002:** | **CA taxable income** |
|---|---|
| Passive income before suspended losses | $11,000 |
| Suspended passive loss, resident period | (5,235) |
| Passive loss, nonresident period | (1,260) |
| Passive income, 2002 | $ 4,505 |

## 3900 OTHER STATE TAX CREDIT (OSTC)

California allows a credit against net tax for tax paid to another state on income that is taxed by both states. Taxpayers cannot apply the credit against city, local or foreign taxes paid.

### Residents

For California residents to claim the credit:

- The tax must be paid to a state that does not allow California residents a credit against taxes imposed by that state. See California Schedule S for a listing of the applicable states.
- The income must have its source in the **other state**. California law and its associated case decisions are the authority for the determination of the source of income, or any matter affecting the computation regardless of any provision or interpretation of the law of the other state.
- The same income must be taxed by both states. Generally, income that is taxed by California and the other state will be the same amounts. However, the double-taxed income amounts reported on California Schedule S, Parts 1(b) and 1(c) may be different because of differences in California and the other state's tax laws, or because of basis differences.
- Substantiation must be provided showing that a tax return was filed with the other

state.

- Substantiation must be provided that taxes were paid to the other state.

See R&TC Section 18001 and CCR Regulations Section 18001-1.

**Example 1**

John filed a California resident return for 2000. He claimed the other state tax credit for taxes paid to New York attributable to wages he earned while working temporarily in New York. A copy of John's 2000 New York nonresident return was attached to the California return indicating he paid income tax to New York on the wage income.

**Determination:**

Residents of California are allowed the other state tax credit for net income taxes paid to New York. John is allowed the other state tax credit because the source of the wage income was in New York and the same wage income was taxed by both California and New York.

**Nonresidents**

For nonresidents of California to claim a credit:

- The tax must be paid to a state that allows California residents a credit against taxes imposed by that state. See California Schedule S for a listing of the applicable states.
- The income must have its source in **California**. California law and its associated case decisions are the authority for the determination of the source of income, or any matter affecting the computation regardless of any provision or interpretation of the law of the other state.
- The same income must be taxed by both states. Generally, income that is taxed by California and the other state will be the same amounts. However, the double-taxed income amounts reported on California Schedule S, Parts 1(b) and 1(c) may be different because of differences in California and the other state's tax laws, or because of basis differences.
- Substantiation must be provided showing that a tax return was filed with the other state.
- Substantiation must be provided showing that taxes were paid to the other state.

See R&TC Section 18002 and CCR Regulations Section 18001-2.

**Example 2**

Susan filed a California nonresident return for 2000 and reported she was an Arizona resident. She claimed the other state tax credit for taxes paid to Arizona attributable to wages she earned while working temporarily in California. A copy of Susan's 2000 Arizona resident return was attached to the California nonresident return indicating she paid income tax to Arizona on the wage income.

**Determination:**

Residents of Arizona are allowed the other state tax credit for taxes paid to California. Susan is allowed the other state tax credit because the source of the wage income was in California and the same wage income was taxed by both California and Arizona.

### Part-Year Residents

For part-year California residents to claim the credit

- Follow the resident rules for the period they were residents.
- Follow the nonresident rules for the period they were nonresidents.

### Partners and S corporation Shareholders:

Members of partnerships and S corporation shareholders are allowed to treat their pro rata share of tax paid to another state by the partnership or S corporation as if it had been paid by the partner or shareholder. See R&TC Section 18006.