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August 23, 2000

Information Letter
2000-275

Re: *****

Dear *****:

Your letter of ***** has been referred to me for response. In that letter, you explain that you have previously submitted these questions to FTB's web site, and the response referred you to the Legal Branch.

For your information I have provided a copy of FTB's Law Summary, Nonresident or Part-Year Resident Tax Liability, which discusses the California Method of taxation of nonresident income required by California law. I have numbered your specific questions, and will provide comments and answers below.

1. *Form 540 NR includes a calculation which includes a worksheet/table format with columns A through E to determine a ratio for apportionment of taxes. My questions surround the application of this ratio, and taxation of income. California Revenue and Taxation Code [RTC] section 17951 states: "In the case of nonresident taxpayers the gross income includes only the gross income from sources within this state."*

Would it be correct to presume then that gross income from sources not within the state are not taxable for nonresidents?

1. Answer: RTC section 17951 must be read in light of RTC section 17041, which provides the method of computation of tax for a nonresident. Under section 17041(b), a nonresident first computes tax on income from all sources as if he were a full year resident of California, multiplied by the ratio of California adjusted gross income (AGI) to total AGI from all sources. (See Law Summary section 1.) While items of income from sources not within the state are used in the computation of nonresident tax, the imposition of the tax itself is on gross income from California sources (section 17951). See Law Summary section 3.

2. *If Gross Income (per section 17951) includes only sources of income from within the state, then isn't it correct to say that section 17594 (granting authority to*

FTB to allocate and apportion gross income [from within and without the state]) applies only to gross income from sources within the state?

2. Answer: Section 17594 allows FTB to prescribe rules and regulations to determine what income is to be treated as California source income and what income is to be treated as derived from sources "without" (outside) California. For example, the regulations under section 17951 (written under the authority of section 17594) set forth specific rules for how amounts paid to nonresident athletes and entertainers are apportioned and allocated among California and other states. Therefore, section 17594 "applies to" (considers) all income from all sources, which is then allocated as in-state or out-of-state depending on its source.

3. *Are these two sections (i.e., 17951 and 17954) contradictory and/or mutually exclusive?*

3. Answer: No. As explained above, 17954 relates to how income is sourced between California and other states. Section 17951 applies after the apportionment is made to describe the income from California sources. That figure is in turn used as a component of the ratio prescribed by section 17041 in the actual computation of tax liability.

4. *Column B [of Schedule CA, Form 540NR] is to be used for listing the [items of] gross income [subtractions] ... which is to be excluded in the calculation of taxes due to the State of California. **The FTB asserts that this column is to be used for income that is not taxable under California law.** Considering section 17951, wouldn't that include [items of income from] all sources which are not from within California?*

4. Answer: No. The actual language of the Schedule CA instructions explains that Columns B and C (Subtractions and Additions) are used to show adjustment to income from all sources because of *differences* in California and federal law, not all income that is "not taxable" under California law. For example, California law differs from federal law in the area of taxability of federal bond interest. Column D then shows the total amounts from all sources using California law as required by section 17041. It is Column E of the schedule where the source of income items is reflected.

5. *[Under the California Method required by Section 17041] It is apparent that FTB is actually assessing taxes on income not taxable per California law. Albeit the resulting tax is then apportioned as a calculated ratio. However, the tax is nonetheless first calculated then reduced per the ratio. Regardless of the rate at which it is ultimately calculated or reduced to, the FTB is applying these rules and regulations for determining total tax to income which has been clearly and specifically excluded from their jurisdiction as per section 17951. Correct?*

5. Answer: No. Again, the question confuses the use of income from all sources as a component of the formula used to compute the tax with a tax directly on income from out-of-state sources. See sections 3, 5 and 6 of the law summary.

6. *Said another way, for nonresidents Section 17951 excludes from consideration gross income which is not from a source within the state. However, the FTB through their application of the A-E formula in Form 540NR has overstepped their authority and requires inclusion of that gross income which has been specifically excluded, to first determine a tax based on an income which includes specifically excluded income, but then reduces the tax. Correct?*

6. Answer: No. See Answer 5, above. Income from all sources is required by law to be used in the computation of the formula under Section 17041. FTB has followed that law exactly in creating the Form 540NR Schedule CA, columns A-E.

7. *It appears that the [Revenue and Taxation Code] (especially Section 17951 requires that, for nonresidents, taxes should only be calculated using gross income from sources within the state. If done otherwise, isn't the FTB actually illegally levying taxes against income not from sources within the state? Regardless of the rate which is ultimately applied, the fact is that FTB has calculated a tax considering income which has been clearly removed from their jurisdiction.*

7. Answer: Although this was not phrased as a question, I should point out that this is the same argument advanced by the taxpayer in *Brady v. New York*, cited in section 6 of the law summary. The New York court explained the rationale behind the use of the nonresident ratio computation as follows:

Plaintiffs would have us compare them to New York residents with a total income equivalent to plaintiffs' New York income alone. Plaintiffs would urge, for example, that a nonresident earning \$20,000 in New York, but with reported income of \$100,000, should be taxed at the same rate as a resident with an income of \$20,000. But plaintiffs' hypothetical taxpayers are not similarly situated in terms of ability to pay. Similarly situated taxpayers are those with the same total income. * * *

Plaintiffs' real quarrel, in the end, is with the graduated tax. A system of progressive taxation apportions the tax burden based on ability to pay-- higher income taxpayers can pay more and are therefore taxed at a higher rate than lower income taxpayers. This system does not implicate the State or Federal Constitution so long as the rates are applied, as here, in a nondiscriminatory manner and only to the taxable New York income.

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For your convenience, I have enclosed a copy of the full opinion in *Brady v. New York*.

Very truly yours,

Bruce R. Langston
Tax Counsel

Enclosures: Law Summary – Nonresident or Part-Year Resident Tax Liability
Brady v. New York
Revenue and Taxation Code section 17041