Residency and Sourcing Technical Manual

Table of Contents

RSTM 1000   OVERVIEW
RSTM 2000   RESIDENCY LAWS, TERMS, CONCEPTS
RSTM 3000   SOURCE OF INCOME LAWS, TERMS, CONCEPTS
RSTM 4000   RESIDENCY AND SOURCING AUDIT GUIDELINES
1000 OVERVIEW

RSTM 1100  Introduction
RSTM 1200  Audit Objectives and Audit Standards

1100 Introduction

We designed the Residency and Sourcing Technical Manual (RSTM) to assist you in conducting residency and source of income audits.

Franchise Tax Board Notice 94-8 explains that manuals provide you with guidance, but are not authoritative. Neither you nor the taxpayer can cite the manual to support a tax position. This manual is not a substitute for researching the laws and court or Office of Tax Appeals (OTA) decisions pertinent to an audit issue.

Unless otherwise specified, all section references relate to sections of the California Revenue and Taxation Code (R&TC) or the California Code of Regulations (CCR) Title 18, Division 3. Statements of law in the RSTM reflect the law on the manual’s revision date.

The manual contains three major sections:

RSTM 2000  Residency Laws, Terms, and Concepts
RSTM 3000  Source of Income Laws, Terms, and Concepts
RSTM 4000  Residency and Sourcing Audit Guidelines

1200 Audit Objectives and Audit Standards

You conduct yourself and your work in a manner that is both fair and effective. You correctly apply and administer the tax laws in a reasonable, practical, fair, and impartial manner. You conduct your audits in a reasonable manner within the boundaries of the law, with sound administration, minimal delay, courtesy, and respect to taxpayers. To achieve your objective, you conduct your audits in a manner which is not unnecessarily burdensome, costly, or intrusive to taxpayers. Our goal is to continually strive for quality, effectiveness, and economy in the services provided to taxpayers.

During the audit process, you identify issues; obtain, evaluate, and document information; and arrive at the correct determination. Your decision is supported by a reasonable interpretation of the tax laws. You conduct your audits in adherence with the following audit standards in all cases:

Legality – Ensure audit activities and conclusions agree with established laws and legal interpretations.

Objectivity - Examine all relevant, available facts fairly and without bias.
**Timeliness** - Conduct and complete audits with minimum inconvenience to taxpayers.

**Supportability** - Adequately support recommendations with facts and law.

Refer to the Manual of Audit Procedures, [MAP](#), for further information concerning audit procedures.
2000 RESIDENCY LAWS, TERMS, AND RESIDENCY CONCEPTS

RSTM 2100  Definition of Resident
RSTM 2200  Definition of Temporary or Transitory
RSTM 2300  Seasonal Visitors, Tourists, and Guests
RSTM 2400  Presumption of Residency
RSTM 2500  Definition of Domicile
RSTM 2600  Domicile v. Residency
RSTM 2700  Definition of Nonresident
RSTM 2800  Definition of Part-Year Resident
RSTM 2900  Military Personnel

2100 Definition of Resident

R&TC Section 17014(a) defines "resident" as:

- Every individual who is in this state for other than a temporary or transitory purpose; and
- Every individual domiciled in this state who is outside the state for a temporary or transitory purpose.

Under this definition, an individual may be a resident of California although not domiciled in California, and, conversely, may be domiciled in California without being a resident of California. Residency determines what income is taxable by California (CCR Section 17014).

The theory behind California residency law is to define the class of individuals who should contribute to the support of this state (CCR Section 17014).

R&TC Section 17014(b) provides a special rule for certain United States Government officials and their spouses. If those individuals have a California domicile, we will consider their absences from this state as temporary or transitory. They remain California residents. This rule applies to the following persons:

- Any elected U.S. official.
- Anyone on the staff of a member of the U.S. Congress.
- Any presidential appointee, subject to Senate confirmation, other than military and Foreign Service career appointees.
R&TC Section 17014(c) provides that any individual who is a resident of California remains a resident even though temporarily absent.

2200 Temporary or Transitory Purpose

CCR Section 17014(b) provides a detailed discussion of the meaning of "temporary or transitory purpose." According to this regulation, the determination of whether or not an individual is in this state for temporary or transitory purposes depends to a large extent upon the facts and circumstances of each particular case.

Generally, we consider an individual to be in California for a temporary or transitory purpose, and therefore a nonresident of California, if he or she is:

- Simply passing through this state.
- Here for a brief rest.
- Here for a vacation
- Here for a short period to complete a particular transaction, perform a particular contract, or perform a particular engagement.

Example 1

James and Janice are domiciled in Minnesota where they have maintained their family home for seven years. James works for a state agency in Minnesota. In October 2005, James took a six-month leave of absence to become a temporary consultant for a California company. James and Janice moved to Los Angeles, CA in October 2005, where they rented an apartment and opened a checking account. Their home in Minnesota was left vacant and they retained their Minnesota bank accounts. They stayed in California from October 2005, to April 2006, and returned to Minnesota in April 2006.

Determination:

James and Janice were in California for a short period in order for James to complete a particular engagement as a temporary consultant. James and Janice are nonresidents of California because they were in California for a temporary or transitory purpose.

An individual will be considered to be in California for other than temporary or transitory purposes, and therefore a California resident, if he or she is in this state:

- To recuperate from injury or illness for a relatively long or indefinite period.
- For a business purpose which will require a long or indefinite period to accomplish.
- For employment in a position that may last permanently or indefinitely.
- For retirement with no definite intention of leaving shortly.
Example 2

Bob is domiciled in Ohio and has lived there for 50 years. Two years ago Bob developed a serious medical condition. His doctor told him to live in California until he recovers. The illness may last for several years. Bob took his doctor's advice and moved to California two years ago.

Determination:

Bob is in California for an indefinite period in order to recuperate from an illness. He is a California resident because his stay in California is not for a temporary or transitory purpose.

Example 3

Bob and Cindy, husband and wife, domiciled in Minnesota where they maintained their family home, come to California each November and stay here until the middle of March. Originally they rented an apartment or house for the duration of their stay here but three years ago they purchased a house here. The house is either rented or put in the charge of a caretaker from March to November. Bob has retired from active control of his Minnesota business but still keeps office space and nominal authority in it. He belongs to clubs in Minnesota, but to none in California. He has no business interests in California. Cindy has little social life in California, more in Minnesota, and has no relatives in California.

Determination:

Neither Bob nor Cindy is a resident of California. The connection of each to the state of domicile in each year is closer than it is to California. Their presence here is for a temporary or transitory purpose.

Note: If, in the foregoing example, the facts are reversed so that California is the state of domicile and the persons are visitors in another state or country, the persons are residents of California.

CCR Section 17014(b) provides that the state with which a person has the closest connections during the taxable year is the person’s state of residence. In the Appeal of Richard L. and Kathleen K. Hardman, 75-SBE-052, August 19, 1975, the BOE held that the connections which a taxpayer maintains in this and other states are important objective indications of whether presence in or absence from California is for a temporary or transitory purpose.

In the Appeal of Stephen D. Bragg, 03-SBE-002, May 28, 2003, the BOE included the following list of factors which, while not exhaustive, inform taxpayers of the type and nature of connections the BOE and the Franchise Tax Board find informative when determining residency:

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

The location of the taxpayer's bank and savings accounts.

The origination point of the taxpayer's checking account transactions and credit card transactions.

The state wherein the taxpayer maintains memberships in social, religious, and professional organizations.

The state wherein the taxpayer registers his automobiles.

The state wherein the taxpayer maintains a driver's license.

The state wherein the taxpayer maintains voter registration and the taxpayer's voting participation history.

The state wherein the taxpayer obtains professional services, such as doctors, dentists, accountants, and attorneys.

The state wherein the taxpayer is employed.

The state wherein the taxpayer maintains or owns business interests.

The state wherein the taxpayer holds a professional license or licenses.

The state wherein the taxpayer owns investment real property.

The indications in affidavits from various individuals discussing the taxpayer's residency.

It is particularly relevant to determine whether the taxpayer substantially severed his or her California connections upon departure and took steps to establish significant connections with the new place of abode. It is also necessary to determine whether the connections in California were maintained in readiness for his or her return. See the Appeal of Richard L. and Kathleen K. Hardman, supra.

Whether a person was in California for other than a temporary or transitory purpose must be determined by examining all of the facts. Mere formalisms such as changing voting registration to another state or statements to the effect that the taxpayer intended to be a resident of another state are not controlling. See the Appeal of Tyrus R. Cobb, 59-SBE-014, March 26, 1959.

Note that retention of some contacts such as bank accounts and a driver's license may only be a reflection of the taxpayer's past and may not be inconsistent with an absence for other than temporary or transitory purposes. See the Appeal of Richard L. and Kathleen K. Hardman, supra.

In the Appeal of Brent L. Berry, 71-SBE-007, March 22, 1971, where the taxpayer was domiciled in California but played football for a Canadian football team, the BOE determined that the taxpayer's presence outside of California only during the playing season was considered temporary or transitory.

In the Appeal of Joe & Gloria Morgan, 85-SBE-078, January 6, 1986, the BOE determined that the location of the taxpayer during the off-season was a significant factor in deciding whether their absences were temporary or transitory in nature.

In the Appeal of Jimmy Childs, 83-SBE-128, June 21, 1983, the BOE determined that a professional football player's customary returns to California during the off-season are inconsistent with the acquisition of a permanent place of residence outside the state.

2300 Seasonal Visitors, Tourists, and Guests

CCR Section 17014(b) provides that an individual whose presence in California does not exceed an aggregate of six months within a taxable year and who is domiciled without the state and maintains a
permanent abode at the place of his domicile will be considered as being in this state for temporary or transitory purposes. However, he or she must not engage in any activity or conduct within this state other than that of a seasonal visitor, tourist, or guest.

The following connections with California will not, by themselves, cause a seasonal visitor, tourist, or guest to lose his or her status as such:

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

**Example 1**

Bill and Sue lived and worked in North Dakota for 20 years until their retirement in the summer of 2005. Beginning the winter of 2005, Bill and Sue spend four months each year in California. They spend the remaining eight months in North Dakota. While in North Dakota, they live in a home they have owned since 1995. They hold valid North Dakota driver's licenses, are registered to vote in North Dakota, and maintain North Dakota bank accounts. Bill and Sue also own a California home, which they use while in California. They also opened a California checking account for their personal expenses and are members of a California country club. While in California, they do not engage in any California business activities.

**Determination:**
Bill and Sue are considered to be seasonal visitors, in California for temporary or transitory purposes. Therefore, they are nonresidents of California.

### 2400 Presumption of Residence

*R&TC Section 17016* states: “Every individual who spends in the aggregate more than nine months of the taxable year within this state shall be presumed to be a resident. The presumption may be overcome by satisfactory evidence that the individual is in the state for a temporary or transitory purpose.”

Note that *R&TC Section 17016* merely provides a presumption of residence. The presumption can be overcome. For example, in the *Appeal of Edgar Montillion Woolley*, 51-SBE-005, July 19, 1951, the BOE ruled that the taxpayer was in California for a temporary or transitory purpose even though he was in California for more than nine months during the year. The decision was based on the fact that during his stay in California, Mr. Woolley lived in a hotel on a weekly basis and his departure was delayed because of illness and a studio strike.

*CCR Section 17016* provides that presence within California for less than nine months does not constitute a presumption of nonresidency. On the contrary, a person may be a California resident even though not in this state during any portion of the year.

### 2500 Definitions of Domicile

Domicile is an integral part of the definition of resident. An individual domiciled in California and absent from the state for a temporary or transitory purpose is considered to be a California resident. An individual's domicile also determines whether income received by a husband or wife is community or
separate income.

CCR Regulations Section 17014(c) defines the term "domicile" as the place where an individual has his or her true, fixed, permanent home and principal establishment. It is the place to which, whenever absent, he or she has the intention of returning. It is the place in which a person has voluntarily fixed his or her habitation and the habitation of his or her family. It is the place where a person has the present intention of making a permanent home, until some unexpected event shall occur to induce him or her to adopt another. It is not a place where a person is living for a mere special or limited purpose.

As stated by the California Court of Appeal, "domicile" is the one location with which, for legal purposes, a person is considered to have the most settled and permanent connection. It is the place to which they intend to remain and to which, whenever they are absent, they have the intention of returning. See Whittell v. Franchise Tax Board, 231 Cal.App.2d 278 (1964).

An individual can have only one domicile at a time. Appeal of Dean D. Clemons, 85-SBE-086, Aug. 20, 1985. If an individual has acquired a domicile at one place, the individual retains that domicile until another is acquired elsewhere. Appeal of Anthony J. and Ann S. D'Eustachio, 85-SBE-040, May 8, 1985.

A California domiciliary leaving the state retains his or her California domicile as long as he or she has the definite intention of returning here. This is true regardless of the length or reason of the absence. An individual domiciled in California who leaves the state loses his or her California domicile at the moment he or she abandons any intention of returning to California and locates elsewhere with the intention of remaining there indefinitely. Appeal of Dean D. Clemons, supra.

The concept of domicile involves not only physical presence in a particular place, but also the intention to make that place one's home. See the Appeal of Anthony J. and Ann S. D'Eustachio, supra.

In order to change one's domicile, a person must actually move to a new residence and intend to remain there permanently or indefinitely. See Noble v. Franchise Tax Board, 118 Cal.App. 4th 560 (2004).

The burden of proving the acquisition of a new domicile is on the person asserting that domicile has been changed. See the Appeal of Frank J. Milos, 1984-SBE-042, February 28, 1984. Retention of significant California connections is relevant to the determination of a taxpayer's domicile. See Appeal of Anthony V. and Beverly Zupanovich, 76-SBE-002, Jan. 6, 1976.

The location where one maintains a marital abode has been viewed as a significant factor in resolving the question of domicile. See Aldabe v. Aldabe, 209 Cal. App. 2d 453, [26 Cal. Rptr. 208]; Appeal of Olav Valderhaug, 54-SBE-007, Feb. 18, 1954; Appeal of Annette Bailey, 76-SBE-016, March 8, 1976; Appeal of Charles P. Varn, 77-SBE-104, July 26, 1977.

**Example 1**

Adam, who is domiciled in Illinois, comes to California on business, but intends to return to Illinois as soon as his business in California is completed. He maintains a California home while in California and stays in California for 11 months.
Determination:
Adam retains his Illinois domicile. His stay in California is for a limited purpose.

Example 2
Mark moved from Alaska to California in October 2000, to begin a permanent job. He sold his home in Alaska and purchased a home in California. He moved all his personal belongings to California, opened a California bank account, and obtained a California driver's license. He has no intention of returning to Alaska.

Determination:
Mark became a California domiciliary in October 2000, when he moved to California. He came to California with the intention to remain here indefinitely with no fixed intention of returning to Alaska.

Example 3
Allen and his wife Ellen were both born and raised in California. Upon graduation from a California college, Allen obtained employment in Los Angeles, CA. In 1999, Allen was sent to France for a one-year assignment. Ellen remained at their home in California with their two children. While in France, Allen rented an apartment and joined a local soccer league. He returned to California in 2000.

Determination:
Allen remained a California domiciliary during his absence. He did not sever his ties with California and the ties established with France did not show that he intended to remain there permanently.

2600 Domicile v Residency

Domicile and residency are not synonymous. California distinguishes them as two separate concepts. For income tax purposes, residency determines what income is taxable to California. Domicile is an important component of residency and determines whether income is split between spouses.

Domicile is the place where an individual has his or her true, fixed, permanent home and principal establishment (CCR Regulations Section 17014(c)). Domicile requires both physical presence in a particular locality and the intent to make this locality one's permanent abode. Residence is any factual place of abode of some permanency that is more than a mere temporary sojourn. See Whittell v. Franchise Tax Board, supra.

An individual can have only one domicile at any given time, but can have several residences. See Whittell v. Franchise Tax Board, supra.

The key distinction between domicile and residency is intent. A new domicile is acquired by the actual change of residence in a new place of abode, coupled with the intention to remain there either permanently or indefinitely without any fixed or certain purpose to return to the former place of abode. Appeal of Robert J. and Kyung Y. Olsen, 80-SBE-134, October 28, 1980.

A determination of residence cannot be based solely upon the declared intention of the parties, but must have its basis in objective facts. Appeal of Nathan H. and Julia M. Juran, 68-SBE-004, January 8, 1968.
In determining residency, voluntary physical presence is a factor of greater significance than the mental intent or outward formalities of ties to another state. See *Whittell v. Franchise Tax Board*, supra.

Frequently, a person's domicile and residence are the same physical location. *Whittell v. Franchise Tax Board*, supra. However, a person's domicile and residence may not be the same. See the *Appeal of Warren L. and Marlys Christianson*, 72-SBE-022, July 31, 1972.

An individual may be a resident although not domiciled in this state and, conversely, may be domiciled in this state without being a resident. *CCR Section 17014* and the *Appeal of Warren L. and Marlys Christianson*, 72-SBE-022, July 31, 1972.

### 2700 Definition of Nonresident

*R&TC Section 17015* defines "nonresident" as:

- Every individual other than a resident.

Therefore, if an individual is not a resident, he or she is a nonresident.

If the spouse and children of a California nonresident are in this state for other than a temporary or transitory purpose, they are residents of California.

**For taxable years beginning on or after January 1, 1994:**

*R&TC Section 17014(d)* states that an individual who is domiciled in this state but is absent from this state for an uninterrupted period of at least 546 consecutive days (18 months) under an employment-related contract shall be considered outside the state for other than a temporary or transitory purpose and is a nonresident of California. A taxpayer's return to California for up to 45 days during the tax year will be disregarded in determining the 546 consecutive days. This definition applies to a spouse accompanying the taxpayer.

This definition does not apply if:

- The individual or spouse has income from intangibles in excess of $200,000 in any taxable year the employment related contract is in effect.
- The principal purpose of the individual's absence is to avoid taxes.

**If the provisions of R&TC Section 17014(d) are not met:**

When a California domiciliary works outside the State, his or her absence will be considered as being for other than a temporary or transitory purpose if the work is expected to last a long, permanent, or indefinite period of substantial duration. See the *Appeal of Anthony V. and Beverly Zupanovich*, 76-SBE-002, January 6, 1976.

The fact that a foreign assignment ends sooner than expected does not require a conclusion that the assignment was for a temporary or transitory purpose. See the *Appeal of Jeffrey L. and Donna S. Egeberg*, 85-SBE-075, July 30, 1985 and the *Appeal of William G. and Susan G. Crozier*, 92-SBE-005, April 23, 1992.
Permanent departure is not required. The taxpayer only needs to be absent for other than a temporary or transitory purpose. See the Appeal of Basil K. and Floy C. Fox, 86-SBE-071, April 9, 1986.

2800 Definition of Part-Year Resident

R&TC Section 17015.5 (applicable for taxable years beginning on or after January 1, 2002) defines "part-year resident" as a taxpayer who meets both of the following conditions during the same taxable year:

- Is a resident of California during a portion of the taxable year.
- Is a nonresident of California during a portion of the taxable year.

2900 Military Personnel

R&TC Section 17022 defines "military or naval forces of the United States" and "armed forces of the United States" to include all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force. Members of the Marine Corp are included as Navy personnel. The terms also include the Coast Guard. Members of such forces include commissioned officers and personnel below the grade of commissioned officer.

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

- Nonresident service members who come to California under military orders do not become a resident solely because of such orders.

A service member is usually domiciled in the state from which he or she entered the service. Military personnel who are California residents and assigned a homeport in California remain residents while at sea. See FTB Pub 1032 – Tax Information For Military Personnel.

If a service member establishes a California domicile while stationed in California, the military compensation is taxable. If a service member files a declaration with the military showing California as the legal residence, we treat the declaration as presumptive evidence of California residence. A change of "home of record" does not necessarily change a service member's state of residence.

According to R&TC Section 18521 (formerly Section 18402), a married couple may file jointly or separately when either spouse is an active member of the armed forces of the United States.

These special rules apply to military personnel only. They do not apply to civilian employees of the military.
3000 SOURCE OF INCOME LAWS, TERMS, AND CONCEPTS

RSTM 3100 California Taxation
RSTM 3200 Community Income
RSTM 3300 Real or Tangible Personal Property
RSTM 3310 Business, Trade, or Profession
RSTM 3320 Partnerships, S corporations, and Certain Trusts
RSTM 3330 Gains and Losses From the Sale or Trade of Business Property
RSTM 3340 Deferred Gains and Losses (like-kind exchanges)
RSTM 3350 Intangible Personal Property
RSTM 3360 Capital Gains and Losses
RSTM 3400 Compensation for Personal Services
RSTM 3500 EQUITY-BASED COMPENSATION
RSTM 3600 Qualified Pension, Profit Sharing, and Stock Bonus Plans
RSTM 3610 Individual Retirement Accounts (IRAs)
RSTM 3700 Installment Sales
RSTM 3710 Estates and Trusts
RSTM 3720 Tax Treaties with Foreign Countries
RSTM 3730 Covenant Not to Compete
RSTM 3740 Royalties and Residuals
RSTM 3800 Alimony
RSTM 3810 Deductions
RSTM 3820 Net Operating Losses
RSTM 3830 Alternative Minimum Tax
RSTM 3840 Passive Activity Losses
RSTM 3850 Other State Tax Credit
3100 California Taxes

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:

<table>
<thead>
<tr>
<th>Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages earned in California</td>
<td>$45,000</td>
</tr>
<tr>
<td>Wages earned in Japan</td>
<td>$30,000</td>
</tr>
<tr>
<td>Interest from Nevada bank account</td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$85,000</strong></td>
</tr>
</tbody>
</table>

**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:

<table>
<thead>
<tr>
<th>Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages earned in California</td>
<td>$45,000</td>
</tr>
<tr>
<td>Wages earned in Japan</td>
<td>$30,000</td>
</tr>
<tr>
<td>Interest from Nevada bank account</td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$85,000</strong></td>
</tr>
</tbody>
</table>

**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:

1. Is a resident of this state during a portion of the taxable year.
2. 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:

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

**Key Definitions**

<table>
<thead>
<tr>
<th>California taxable income:</th>
<th>California adjusted gross income (AGI) less California itemized or standard deductions.</th>
</tr>
</thead>
<tbody>
<tr>
<td>California AGI:</td>
<td>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.</td>
</tr>
<tr>
<td>Total AGI:</td>
<td>The adjusted gross income from all sources for the entire taxable year.</td>
</tr>
<tr>
<td>California itemized or standard deductions:</td>
<td>Determined by applying the ratio of California AGI to total AGI to all itemized or standard deductions allowed to California residents.</td>
</tr>
<tr>
<td>Total taxable income:</td>
<td>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.</td>
</tr>
</tbody>
</table>

**Percentage Calculations**

<table>
<thead>
<tr>
<th>Itemized or standard deductions:</th>
<th>Divide the California AGI by the total AGI (not to exceed 1.0):</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>( \frac{\text{California AGI}}{\text{Total AGI}} )</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax rate:</th>
<th>Divide the tax on total taxable income by the total taxable income:</th>
</tr>
</thead>
</table>
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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate taxes</td>
<td>$1,200</td>
<td>California house</td>
</tr>
<tr>
<td></td>
<td>800</td>
<td>Florida house</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>17,000</td>
<td>California house</td>
</tr>
<tr>
<td></td>
<td>3,500</td>
<td>Florida house</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>1,500</td>
<td>New York Firefighters’ Fund</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$24,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>California AGI</td>
<td>$65,000</td>
<td>California wages</td>
</tr>
<tr>
<td></td>
<td>3,000</td>
<td>(Interest earned while a CA resident)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$68,000</td>
</tr>
<tr>
<td>Total AGI</td>
<td>$80,000</td>
<td>(Wages from all sources)</td>
</tr>
<tr>
<td></td>
<td>4,000</td>
<td>(Interest income from all sources)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$84,000</td>
</tr>
<tr>
<td>CA itemized deductions</td>
<td>$24,000</td>
<td>(Total itemized deductions)</td>
</tr>
</tbody>
</table>
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, U.S. territory or country, we consider his or her income community income. If the acquiring spouse is domiciled in a separate property state, U.S. territory or country, we consider his or her income separate income.

The Appeal of Richard and Eva Taylor, 88-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.

<table>
<thead>
<tr>
<th>Wages</th>
<th>Mark</th>
<th>Lisa</th>
</tr>
</thead>
<tbody>
<tr>
<td>California, $70,000</td>
<td>$35,000</td>
<td>$35,000</td>
</tr>
<tr>
<td>Iowa, $30,000</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Total:</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Income taxable by California</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mark’s 50 percent share of his wages:</td>
</tr>
<tr>
<td>Lisa’s 50 percent share of Mark’s wages earned in California:</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

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 are community property states and U.S. territories (countries not listed):

<table>
<thead>
<tr>
<th>Arizona</th>
<th>Louisiana</th>
<th>Puerto Rico</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>Nevada</td>
<td>Texas</td>
</tr>
<tr>
<td>Guam</td>
<td>New Mexico</td>
<td>Washington</td>
</tr>
<tr>
<td>Idaho</td>
<td>Northern Mariana Islands</td>
<td>Wisconsin</td>
</tr>
</tbody>
</table>

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, 60-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 Regulation 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 corporate apportionment rules of the Uniform Division of Income for Tax Purposes Act, as contained in R&TC sections 25120-25139 and their related regulations (Cal. Code Regs., tit. 18, §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.

**SINGLE SALES FACTOR APPLIES.** "An apportioning trade or business," which includes a nonresident’s business, trade, or profession that is carried on within and without California is required to apportion business income using the single sales factor.

Proposition 39, which added R&TC section 25128.7 for taxable years beginning on or after January 1, 2013, requires "all business income of an apportioning trade or business, other than an apportioning trade or business described in subdivision (b) of Section 25128, shall be apportioned to this state by multiplying the business income by the sales factor."

CCR sections 17951 through 17954 require such businesses to source business income in accordance with the provisions of the corporate apportionment rules.

CCR section 17951-4 requires that a partner’s distributive share of partnership income derived from sources within California (with some modifications) also be determined using corporate apportionment rules. This means "an apportioning trade or business" regardless of the form of ownership (e.g. sole proprietorship, partnership, limited liability company, or corporation), that carries on within and without of California is required to apportion the nonresident’s business income using the single sales factor.

Whether the trade or business is the partnership’s business (if not unitary with the trade or business of its partner), or the partnership interest is combined with the partner’s trade or business (if the partnership’s activities are unitary with the activities of its partner, notwithstanding ownership requirements), the business income of the trade or business would be apportioned using the single sales factor, unless the trade or business meets one of the exceptions of R&TC section 25128(b).

**Example 2**

John is a nonresident of California who owns a sole proprietorship that derives income from inside and outside California. Does the single-sales factor apply?

**Determination:**

Yes, a nonresident individual who has income from a business, trade, or profession and who must apportion its business income to California under CCR section 17951-4, must use the single-sales factor for taxable years beginning on or after 1/1/2013, unless 50% of the gross receipts were derived from a Qualified Business Activity.

**RULES FOR ASSIGNING SALES**
For taxable years beginning on or after 1/1/2011 and before 1/1/2013, sales of other than tangible personal property (i.e. sales of intangibles and services) are assigned for California sales factor purposes using one of the following:

- Market assignment if the taxpayer elected the single-sales factor to apportion business income to California.
- Cost of performance if the taxpayer did not elect to use a single-sales factor.

Under market assignment, sales of other than tangible personal property are assigned to the California sales factor numerator if:

- Sales from services are in California to the extent the purchaser of the service received the benefit of the services in California.
- Sales from intangible property are in California to the extent the property is used in California. In the case of marketable securities, sales are in California if the customer is in California.
- Sales from the sale, lease, rental, or licensing of real property are in California if the real property is located in California.
- Sales from the rental, lease, or licensing of tangible personal property are in California if the property is located in California.

See CCR section 25136-2 for specific rules and examples.

Sales of tangible personal property are in California if at least one of the following applies:

- The property is delivered or shipped to a purchaser in California.
- The property is shipped from California to a state where the taxpayer is not taxable, or the purchaser is the U.S. government.

**Example 3**

Jill, a nonresident of California, owns a web design business that she holds as a sole proprietorship. She works from her home out of state but has customers in various states, including California. For the 2013 taxable year, Jill's sales receipts from California customers are $300,000 out of the total sales receipts everywhere of $1,000,000. Does Jill have a filing requirement in California?

**Determination:**

Yes, nonresident individuals are taxed on all California source income. Jill's sole proprietorship is carrying on a business in and out of California and will be required to apportion its income to California using UDITPA rules. Under the market assignment rules, sales of services are assigned to California if the purchaser of the service received the benefit of the service in California. Accordingly, $300,000 will be assigned to the California sales factor numerator for Jill's sole proprietorship and Jill would apportion 30% ($300,000 CA sales/$1,000,000 total sales) of its business income from her sole proprietorship to California.

**Example 4**
Jack performs tax and accounting services both in California and Nevada, but is located in Nevada. Jack performs tax and accounting services for a California client. Those fees are sourced to California, even if Jack performs all services for this client in Nevada. If however, the practitioner performs no services for a California client, the services are not taxable to California.

Prior to enactment of the single sales factor, Jack computed California apportioned income based on a formula that sourced income based on Jack's payroll, property, and sales. This computation included a percentage of profits apportioned to the state of residence and sourced revenue from services to the state where the services were performed. This no longer applies.

3320 Partnership, 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.


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.

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:

<table>
<thead>
<tr>
<th>Period of Residency</th>
<th></th>
<th>Period of Nonresidency</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>November 1, 2001 - June 9, 2002</td>
<td></td>
<td>June 10, 2002 - October 31, 2002</td>
<td></td>
</tr>
<tr>
<td>Washington net income</td>
<td>$5,600</td>
<td>Washington net income</td>
<td>$4,400</td>
</tr>
<tr>
<td>California net income</td>
<td>4,000</td>
<td>California net income</td>
<td>2,000</td>
</tr>
<tr>
<td>Total net income</td>
<td>$9,600</td>
<td>Total net income</td>
<td>$6,400</td>
</tr>
</tbody>
</table>

**Determination:**

**Step 1**

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

<table>
<thead>
<tr>
<th>Period of Residency</th>
<th></th>
<th>Period of Nonresidency</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total net income</td>
<td>$9,600</td>
<td>California net income</td>
<td>$2,000</td>
</tr>
<tr>
<td>% interest in S corporation</td>
<td>X 50%</td>
<td>% interest in S corporation</td>
<td>X 50%</td>
</tr>
<tr>
<td>2002 distributive share</td>
<td>$4,800</td>
<td>2002 distributive share</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

**Step 2**
Compute the distributive share income to include in California taxable income.

<table>
<thead>
<tr>
<th>Taxable year 2002</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributive share, period of residency</td>
<td>$ 4,800</td>
</tr>
<tr>
<td>Distributive share, period of nonresidency</td>
<td>1,000</td>
</tr>
<tr>
<td>Distributive share income, 2002</td>
<td>$ 5,800</td>
</tr>
</tbody>
</table>

**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:

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of WA real property</td>
<td>$ 15,200</td>
</tr>
<tr>
<td>Sale of stock</td>
<td>2,000</td>
</tr>
<tr>
<td>Total net income</td>
<td>$17,200</td>
</tr>
<tr>
<td>Sale of WA real property</td>
<td>$ 4,400</td>
</tr>
<tr>
<td>Sale of CA real property</td>
<td>10,300</td>
</tr>
<tr>
<td>Total net income</td>
<td>$14,700</td>
</tr>
</tbody>
</table>

**Step 1**

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

<table>
<thead>
<tr>
<th>Period of Residency</th>
<th>Period of Nonresidency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total net income</td>
<td>California net income</td>
</tr>
<tr>
<td>2002 distributive share</td>
<td>2002 distributive share</td>
</tr>
<tr>
<td>60%</td>
<td>60%</td>
</tr>
</tbody>
</table>

**Step 2**
Compute the distributive share income to include in California taxable income.

<table>
<thead>
<tr>
<th>Taxable year 2002</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributive share, period of residency</td>
<td>$ 10,320</td>
</tr>
<tr>
<td>Distributive share, period of nonresidency</td>
<td>6,180</td>
</tr>
<tr>
<td>Distributive share income, 2002</td>
<td>$ 16,500</td>
</tr>
</tbody>
</table>

**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.

<table>
<thead>
<tr>
<th>California Resident Days</th>
<th>California Nonresident Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 2002, through March 31, 2002 = 90 days</td>
<td>April 1, 2002, through December 31, 2002 = 275 days</td>
</tr>
</tbody>
</table>

**Step 2**

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

<table>
<thead>
<tr>
<th>Period of Residency</th>
<th>Period of Nonresidency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributive share</td>
<td>$10,000</td>
</tr>
<tr>
<td>Distributive share</td>
<td>$4,000</td>
</tr>
</tbody>
</table>
income from all sources

<table>
<thead>
<tr>
<th>CA resident days ÷ total days</th>
<th>Nonresident days ÷ total days</th>
<th>Prorated 2002 distributive share</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 2,466</td>
<td>$ 3,014</td>
<td></td>
</tr>
</tbody>
</table>

**Step 3**

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

<table>
<thead>
<tr>
<th>Taxable year 2002</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributive share, period of residency</td>
<td>$ 2,466</td>
</tr>
<tr>
<td>Distributive share, period of nonresidency</td>
<td>3,014</td>
</tr>
<tr>
<td>Distributive share income, 2002</td>
<td>$ 5,480</td>
</tr>
</tbody>
</table>

**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.
Step 2

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

<table>
<thead>
<tr>
<th>Period of Residency</th>
<th>Period of Nonresidency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributive share income from all sources</td>
<td>$10,000</td>
</tr>
<tr>
<td>CA resident days ÷ total days (120 ÷ 365)</td>
<td>X .3288</td>
</tr>
<tr>
<td>Prorated 2002 distributive share</td>
<td>$3,288</td>
</tr>
</tbody>
</table>

Step 3

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

<table>
<thead>
<tr>
<th>Taxable year 2002</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributive share, period of residency</td>
<td>$3,288</td>
</tr>
<tr>
<td>Distributive share, period of nonresidency</td>
<td>$2,685</td>
</tr>
<tr>
<td>Distributive share income, 2002</td>
<td>$5,973</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>California Resident Days</th>
<th>California Nonresident Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1, 2002, through September 30, 2002 = 183 days</td>
<td>January 1, 2002, through March 31, 2002 = 90 days</td>
</tr>
</tbody>
</table>

Step 2

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

<table>
<thead>
<tr>
<th>Period of Residency</th>
<th>Period of Nonresidency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributive share income from all sources</td>
<td>$10,000</td>
</tr>
<tr>
<td>CA resident days ÷ total days (183 ÷ 273)</td>
<td>X .6703</td>
</tr>
<tr>
<td>Prorated 2002 distributive share</td>
<td>$6,703</td>
</tr>
</tbody>
</table>

Step 3

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

<table>
<thead>
<tr>
<th>Taxable year 2002</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributive share, period of residency</td>
<td>$6,703</td>
</tr>
<tr>
<td>Distributive share, period of nonresidency</td>
<td>1,319</td>
</tr>
<tr>
<td>Distributive share income, 2002</td>
<td>$8,022</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Taxable year 2002</th>
<th>Total taxable income</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA Section 1231 gain</td>
<td>$ 3,000</td>
<td>$ 3,000</td>
</tr>
<tr>
<td>CA Section 1231 loss</td>
<td>(2,000)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>WA Section 1231 gain</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>WA Section 1231 loss</td>
<td>(5,000)</td>
<td></td>
</tr>
<tr>
<td>Capital gain</td>
<td>$ 0</td>
<td>$ 1,000</td>
</tr>
</tbody>
</table>

**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:

<table>
<thead>
<tr>
<th>Taxable year 2002</th>
<th>Total taxable income</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA Section 1231 gain</td>
<td>$ 2,500</td>
<td>$ 2,500</td>
</tr>
<tr>
<td>CA Section 1231 loss</td>
<td>(3,000)</td>
<td>(3,000)</td>
</tr>
<tr>
<td>FL Section 1231 gain</td>
<td>1,000</td>
<td></td>
</tr>
</tbody>
</table>
Ordinary loss $0

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](https://www.irs.gov/). 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](https://www.rbt.com/legis/4/r&tc17952.html) 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(a)(1) 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.*, 87-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.

<table>
<thead>
<tr>
<th>Taxable year 2002</th>
<th>Total taxable income</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA capital gain</td>
<td>$ 2,000</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>CA capital loss</td>
<td>(6,000)</td>
<td>(6,000)</td>
</tr>
<tr>
<td>NY capital gain</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>NY capital loss</td>
<td>(2,000)</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$(1,000)</td>
<td>$(4,000)</td>
</tr>
<tr>
<td>Capital loss allowed in 2002</td>
<td>1,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Capital loss carryover to 2003</td>
<td>$ 0</td>
<td>$(1,000)</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>Total taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA capital gain</td>
<td>$2,000</td>
</tr>
<tr>
<td>CA capital loss</td>
<td>(6,000)</td>
</tr>
<tr>
<td>NY capital gain</td>
<td>5,000</td>
</tr>
<tr>
<td>NY capital loss</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$ (1,000)</td>
</tr>
<tr>
<td>Capital loss allowed in 2002</td>
<td>1,000</td>
</tr>
<tr>
<td>Capital loss carryover to 2003</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

### 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

<table>
<thead>
<tr>
<th></th>
<th>Total taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA capital loss</td>
<td>$ (4,000)</td>
</tr>
<tr>
<td>WY capital gain</td>
<td>5,000</td>
</tr>
<tr>
<td>Capital loss carryover</td>
<td>0</td>
</tr>
<tr>
<td>Capital gain income</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

### 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**

<table>
<thead>
<tr>
<th></th>
<th>Total taxable income</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA capital gain</td>
<td>$ 2,000</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>CA capital loss</td>
<td>(6,000)</td>
<td>(6,000)</td>
</tr>
<tr>
<td>NY capital gain</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>NY capital loss</td>
<td>(2,000)</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$(1,000)</td>
<td>$(4,000)</td>
</tr>
<tr>
<td>Capital loss allowed in 2002</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Capital loss carryover to 2003</td>
<td>$ 0</td>
<td></td>
</tr>
</tbody>
</table>

**2003 Restatement**

<table>
<thead>
<tr>
<th></th>
<th>Total taxable income</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA capital loss, 2003</td>
<td>$ (4,000)</td>
<td>$ (4,000)</td>
</tr>
<tr>
<td>WY capital gain</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Capital loss carryover from 2002</td>
<td>(1,000)</td>
<td></td>
</tr>
<tr>
<td>Capital gain or loss</td>
<td>$ 1,000</td>
<td>$ (5,000)</td>
</tr>
<tr>
<td>Capital loss allowed in 2003</td>
<td></td>
<td>3,000</td>
</tr>
<tr>
<td>Capital loss carryover to 2004</td>
<td>$ 0</td>
<td></td>
</tr>
</tbody>
</table>

**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**

<table>
<thead>
<tr>
<th></th>
<th>Total taxable income</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA capital gain</td>
<td>$ 9,000</td>
<td>$ 9,000</td>
</tr>
<tr>
<td>CA capital loss</td>
<td>(5,000)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>TX capital gain</td>
<td>8,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$ 12,000</td>
<td>$ 4,000</td>
</tr>
<tr>
<td>Capital loss carryover from 2003</td>
<td>0</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Capital gain income</td>
<td>$ 12,000</td>
<td>$ 2,000</td>
</tr>
</tbody>
</table>
**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:

<table>
<thead>
<tr>
<th>Before July 1, 2002</th>
<th>After July 1, 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total capital gains</td>
<td>$10,000</td>
</tr>
<tr>
<td>CA source capital gains</td>
<td>7,000</td>
</tr>
<tr>
<td>Total capital losses</td>
<td>(2,000)</td>
</tr>
<tr>
<td>CA source capital losses</td>
<td>(1,000)</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total capital gains</td>
<td>$8,000</td>
</tr>
<tr>
<td>CA source capital gains</td>
<td>4,000</td>
</tr>
<tr>
<td>Total capital losses</td>
<td>(3,000)</td>
</tr>
<tr>
<td>CA source capital losses</td>
<td>(3,000)</td>
</tr>
</tbody>
</table>

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.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CA capital gains, before July 1, 2002</td>
<td>$ 7,000</td>
</tr>
<tr>
<td>CA capital losses, before July 1, 2002</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Total capital gains, after July 1, 2002</td>
<td>8,000</td>
</tr>
<tr>
<td>Total capital losses, after July 1, 2002</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Capital gain before carryover losses</td>
<td>$11,000</td>
</tr>
</tbody>
</table>

**Step 2**

Prorate Peter’s capital loss carryover amounts based upon periods of California residency and nonresidency during 2002.
**Period of Residency**
- 2001 carryover, as if a CA resident for all prior years: $(7,000)
- CA resident days / total days: $(184 ÷ 365) \times .5041$
- Prorated 2001 capital loss carryover: $(3,529)$

**Period of Nonresidency**
- 2001 carryover, as if a nonresident for all prior years: $(5,000)
- Nonresident days / total days: $(181 ÷ 365) \times .4959$
- Prorated 2001 capital loss carryover: $(2,479)$

**Step 3**
Compute Peter's capital gain or loss to include in California taxable income.

**CA taxable income**

<table>
<thead>
<tr>
<th>Taxable year 2002</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain before carryover losses</td>
<td>$11,000</td>
</tr>
<tr>
<td>Capital loss carryover, resident period</td>
<td>$(3,529)</td>
</tr>
<tr>
<td>Capital loss carryover, nonresident period</td>
<td>$(2,479)</td>
</tr>
<tr>
<td>Capital gain, 2002</td>
<td>$4,992</td>
</tr>
</tbody>
</table>

**3400 Compensation for Personal Services**

- **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

**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 employee 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.

NOTE: Income received from independent contractors (i.e. reported on 1099-MISC) is considered income from a trade, business or profession. See RSTM Section 3310.

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:

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

The BOE 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**, 75-SBE-032, April 22, 1975. And the **Appeal of Sam and Betty Spiegel**, 86-SBE-121, June 10, 1986. In the **Appeal of Louis and Betzi Akerstrom**, 60-SBE-009, May 17, 1960, the Board used days in California divided by 365 because the taxpayer took very little vacation.
A decision related to allocating compensation received by a nonresident for services performed within and without California is *Newman v. Franchise Tax Board*, 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. 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*, 86-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

Income from the sale of intangible personal property such as a contract right is taxable as income from sources within this state only if the intangible has a situs in this state. Since taxpayer was only present in California for two days, it was determined there was no California situs. Appeal of McAneeley, 80-SBE-131.

Also, see FTB Chief Counsel Ruling No. 01-201181. Income from a termination of employment contract does not constitute compensation for services rendered, but income from an intangible. Thus, the source of such income is not where the services were provided or would have been provided had the employment relationship not been terminated, but generally at the residence of the former employee at
the time the income is recognized. The income is properly characterized as income from an intangible, the right to continued employment.

NOTE: There is a distinction between a "right to future employment" vs an employee who is "at-will." If a right to future employment is terminated, it is considered intangible personal property and sourced to state of residence. Even despite being reported as wages on a Form W-2.

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, 77-SBE-121, September 28, 1977, and Appeal of Peter and Anita Berk, 84-SBE-101, June 27, 1984. We do not treat reimbursed out-bound moving expenses as California source income.

3500 Equity-Based Compensation

RSTM 3510 Introduction
RSTM 3520 Nonstatutory Stock Options
RSTM 3530 Incentive Stock Options
RSTM 3535 Restricted Stock
RSTM 3540 Employee Stock Purchase Plans
RSTM 3550 California Qualified Stock Options
RSTM 3560 Summary Table
Equity-based compensation, or non-cash compensation, represents a form of ownership interest in a company. The most common form is stock options; however, employers also issue restricted stock and employee stock purchase plans (ESPP).

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 Internal Revenue Code (IRC) Sections 421-424 are referred to as statutory stock options; those that do not meet requirements are referred to as nonstatutory stock options. IRC Section 83 governs nonstatutory stock options and restricted stock.

Statutory stock options consist of incentive stock options and employee stock purchase plans. Nonstatutory stock options are all other options.

In addition to these stock options, California Revenue and Taxation Code (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 equity-based compensation and how to determine what stock option income is taxable by California when a taxpayer changes his or her residency status.

**Key terms**

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grant date</td>
<td>The date the company grants the option to the employee.</td>
</tr>
<tr>
<td>Option price</td>
<td>The price the employee will pay for the stock (also referred to as the grant price or exercise price).</td>
</tr>
<tr>
<td>Exercise date</td>
<td>The date the employee purchases the stock at the option price.</td>
</tr>
<tr>
<td>Vesting date</td>
<td>The date the options become exercisable. For restricted stock, this is the date the options become taxable.</td>
</tr>
<tr>
<td>Qualifying disposition</td>
<td>A disposition that meets the following IRC Section 422 or IRC Section 423 holding period requirements:</td>
</tr>
<tr>
<td></td>
<td>- No sale of the stock within 2 years from the grant date of the option.</td>
</tr>
<tr>
<td></td>
<td>- No sale of the stock within 1 year after the date the taxpayer exercises the option.</td>
</tr>
<tr>
<td>Disqualifying disposition</td>
<td>A disposition that does not meet the holding period requirements of IRC Section 422 or IRC Section 423.</td>
</tr>
</tbody>
</table>
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, 80-SBE-122, October 28, 1980.

Example 1

On March 1, 2010, while a resident of Michigan, Fred was granted nonstatutory stock options. On June 1, 2013, he retired and permanently moved to California. On August 1, 2013, 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, 2013, 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, supra.

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, 2010, while a resident of California, Joan was granted nonstatutory stock options. Joan performed all of her services in California from February 1, 2010, to May 1, 2013, the date she left the company and permanently moved to Texas. On June 1, 2013, Joan exercised her nonstatutory stock options.

**Determination:**

The difference between the fair market value of the shares on June 1, 2013, 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:

\[
\frac{\text{California workdays from grant date to exercise date}}{\text{Total workdays from grant date to exercise date}}
\]

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

**Example 3**

On July 1, 2009, while a resident of Texas, Betty was granted nonstatutory stock options. On July 1, 2010, she was permanently transferred to California. On July 1, 2013, she left the company and permanently moved to Florida. From July 1, 2009 through July 1, 2013, she worked for the company a total of 700 days in California and 300 days in other states. On August 1, 2013, she exercised her options.

**Determination:**

The difference between the fair market value of Betty's shares on August 1, 2013, and the option price is stock option income characterized as compensation for services. The total 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, California will tax 70 percent of Betty's stock option income.

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

<table>
<thead>
<tr>
<th>Disposition Type</th>
<th>Computation</th>
<th>Character</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualifying disposition:</td>
<td>Sales price minus option price</td>
<td>Capital gain</td>
</tr>
<tr>
<td>Disqualifying disposition:</td>
<td>FMV on exercise date minus option price</td>
<td>Ordinary income</td>
</tr>
<tr>
<td>Sales price &gt; FMV on exercise date</td>
<td>Sales price minus FMV on exercise date</td>
<td>Capital gain</td>
</tr>
<tr>
<td>Disqualifying disposition:</td>
<td>Sales price minus option price</td>
<td>Ordinary income</td>
</tr>
<tr>
<td>Sales price &lt; FMV on exercise date</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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.

$100,000 Limit

IRC Section 422 (d) imposes a $100,000 per year limitation on the aggregate fair market value of the incentive stock options exercisable for the first time by an individual during any calendar year. If this limit is exceeded during any year, the remaining options will be treated as nonstatutory stock options. The aggregate fair market value is determined by applying the fair market value at the time the option is granted - not at the time the option vests. The calculation is based on the order in which the options are granted.

Example 1

On January 1, 2008, John was granted 30,000 shares of incentive stock options with a grant price of $20 per share. These options will vest (or become exercisable) equally over a four year period. John plans on exercising these options during tax year 2012.

Determination:

We must determine if the annual $100,000 limit for incentive stock options has been exceeded.

<table>
<thead>
<tr>
<th>Vest Date</th>
<th>Shares Vested</th>
<th>Vest Value</th>
<th>Value Over Limit</th>
<th>Shares Over Limit</th>
<th>ISO Shares Granted</th>
<th>NQ Shares Granted</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/01/2009</td>
<td>7,500</td>
<td>$150,000</td>
<td>$50,000</td>
<td>2,500</td>
<td>5,000</td>
<td>2,500</td>
</tr>
<tr>
<td>01/10/2010</td>
<td>7,500</td>
<td>$150,000</td>
<td>$50,000</td>
<td>2,500</td>
<td>5,000</td>
<td>2,500</td>
</tr>
<tr>
<td>01/01/2011</td>
<td>7,500</td>
<td>$150,000</td>
<td>$50,000</td>
<td>2,500</td>
<td>5,000</td>
<td>2,500</td>
</tr>
<tr>
<td>01/01/2012</td>
<td>7,500</td>
<td>$150,000</td>
<td>$50,000</td>
<td>2,500</td>
<td>5,000</td>
<td>2,500</td>
</tr>
<tr>
<td>Totals</td>
<td>30,000</td>
<td>$450,000</td>
<td>$150,000</td>
<td>2,500</td>
<td>20,000</td>
<td>10,000</td>
</tr>
</tbody>
</table>

As you can see, John has exceeded the limit each year by $50,000 or 2,500 shares. If he exercised all of these options during 2012, only 20,000 shares would be treated as incentive stock options while the remainder would be considered nonstatutory stock options.

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 2

On February 1, 2010, while a resident of Ohio, Peter was granted incentive stock options. On April 1, 2013, he exercised his options. On September 1, 2014, Peter permanently moved to California and sold his stock on October 15, 2014, 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 3

On February 1, 2010, while a resident of Ohio, Sally was granted incentive stock options. On April 1, 2014, she exercised her options. On June 1, 2014, Sally permanently moved to California and sold her stock on October 1, 2014. 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 4**

On March 1, 2010, Mark was granted an incentive stock option. On March 1, 2012, 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, 2013, he permanently moved to Illinois. On June 1, 2013, he sold the stock at a gain.

**Determination:**

Mark must make an AMT adjustment on his 2012 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 2013 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 5**

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, 2011, Harry was granted an option to purchase stock under his company's incentive stock option plan. The option price on April 1, 2011, was $10 per share. On April 1, 2013, 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, 2013, was $50 per share. On July 1, 2013, Harry retired and permanently moved to Florida. On October 15, 2013, 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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of stock, date of sale:</td>
<td>$1,050,000</td>
</tr>
<tr>
<td>Less option price, date of grant:</td>
<td>- 300,000</td>
</tr>
<tr>
<td>Wage income, CA source:</td>
<td>$ 750,000</td>
</tr>
</tbody>
</table>

* 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 2013 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, 2014, when the fair market value of the stock was $60 per share.

Determination:

Tax Year 2013

Harry must make an alternative minimum tax adjustment in tax year 2013 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of stock, date of exercise:</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Less option price:</td>
<td>- 300,000</td>
</tr>
<tr>
<td>AMT adjustment, CA source:</td>
<td>$ 1,200,000</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option price:</td>
<td>$ 300,000</td>
</tr>
<tr>
<td>Plus AMT adjustment:</td>
<td>1,200,000</td>
</tr>
<tr>
<td>AMT basis:</td>
<td>$ 1,500,000</td>
</tr>
</tbody>
</table>

Tax Year 2014
Wage income from a California source is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of stock, date of exercise</td>
<td>$1,500,000</td>
<td>(30,000 shares @ $50 per share)</td>
</tr>
<tr>
<td>Less option price</td>
<td>-300,000</td>
<td>(30,000 shares @ $10 per share)</td>
</tr>
<tr>
<td>Wage income, CA source income</td>
<td>$1,200,000</td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of stock, date of sale</td>
<td>$1,800,000</td>
<td>(30,000 shares @ $60 per share)</td>
</tr>
<tr>
<td>Less FMV of stock, date of exercise</td>
<td>-1,500,000</td>
<td>(30,000 shares @ $50 per share)</td>
</tr>
<tr>
<td>Capital gain, FL source income</td>
<td>$300,000</td>
<td></td>
</tr>
</tbody>
</table>

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

**3535 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.

**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, 2009, 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, 2013, Brad's employer permanently transferred him to California. On March 1, 2014, 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, 2014, and the price Brad paid for the stock on March 1, 2009, 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, 2011, 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, 2011, to December 31, 2013, the date she left the company and permanently moved to Wyoming. On February 1, 2014, Judy’s stock vested.

Determination:
The difference between the fair market value of the stock on February 1, 2014, and the price Judy paid for the restricted stock on February 1, 2011, 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:

\[
\text{California workdays from purchase date to vesting date} \div \text{Total workdays from purchase date to vesting date}
\]

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

Example 3
On November 1, 2010, 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, 2014, she left the company and permanently moved to Texas. From November 1, 2010, through October 1, 2014, Betty worked for the company a total of 700 days in California and 300 days in other states. On November 1, 2014, the stock vested.

Determination:
The difference between the fair market value of Bonnie's stock on November 1, 2014, and the price she paid for the restricted stock on November 1, 2010, 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.

**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
Example 1

On March 1, 2010, while a resident of Massachusetts, Sam's employer granted him options at a discount under the company's stock purchase plan. On March 1, 2012, Sam exercised his options. On December 1, 2012, Sam permanently moved to California and on April 1, 2013, 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.

Nonresident of California on Date of Stock Sale

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, 2010, Michelle's employer granted options to her under the company's employee stock purchase plan. On February 1, 2012, 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, 2012, she permanently moved to Nevada and on January 15, 2013, 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:

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 Summary Table

<table>
<thead>
<tr>
<th>Type</th>
<th>California residents</th>
<th>California nonresidents on the date of NSO exercise</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonstatutory stock option (NSO)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>on the date of NSO exercise:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• California taxes the wage income.</td>
<td>• California taxes the wage income to the extent services were performed in California from the grant date to the exercise date.</td>
<td></td>
</tr>
<tr>
<td>• Possible other state tax credit.</td>
<td>• Possible other state tax credit.</td>
<td></td>
</tr>
<tr>
<td>on the date of stock sale:</td>
<td>on the date of stock sale:</td>
<td></td>
</tr>
</tbody>
</table>
California taxes the capital gain.

California does not tax the capital gain.

**Incentive stock option (ISO)**

*on the date of ISO exercise:*
- If the stock is not sold in the year of exercise, make AMT adjustment.
- Increase AMT basis by the AMT adjustment.

*on the date the stock is sold in a qualifying disposition at a gain:*
- California taxes the capital gain.
- Possible AMT credit.

*on the date the stock is sold in a disqualifying disposition:*
- California taxes the wage income and capital gain (if any).
- Possible other state tax credit.
- Possible AMT credit.

*on the vesting date:*
- California taxes the wage income.
- Possible other state tax credit.

**Restricted Stock (RSU)**

*on the vesting date:*
- California taxes the wage income to the extent services were performed in California from the grant date to the vesting date.
- Possible other state tax credit.
Employee stock purchase plans (ESPP)

- California taxes the ordinary income and capital gain.
- Possible other state tax credit.

California qualified stock options (CQSO) and R&TC Section 17502 provisions are met:

- Same tax treatment as ISO.

California qualified stock options (CQSO) and R&TC Section 17502 provisions are not met:

- 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
- 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 gains income and interest income.

**Determination:**

The capital gains 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, 75-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 Section 17951-6(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 Section 17951-6(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, 89-SBE-027, September 26, 1989; and the Appeal of AlDean and Clara Washburn, 82-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 Section 17951-6(a)(6)).

**The factors are computed as follows:**

**Property Factor**

Property included in the denominator which is assigned to California
Property assigned to the legally enforceable area

**Payroll Factor**

Payroll included in the denominator which is assigned to California
Payroll assigned to the legally enforceable area

**Sales Factor**

Sales included in the denominator which is assigned to California
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 Corporation, 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, (S.D.N.Y. 1931) 47 F.2d 925, aff’d (2d Cir. 1932) 57 F.2d 65. 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, 75-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


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, 83-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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alimony paid:</td>
<td>$12,000</td>
</tr>
<tr>
<td>California AGI*</td>
<td>$ 24,000</td>
</tr>
<tr>
<td>Total AGI*</td>
<td>$240,000</td>
</tr>
<tr>
<td>Alimony deduction:</td>
<td>$ 1,200</td>
</tr>
</tbody>
</table>

* 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alimony paid during residency period</td>
<td>$8,400</td>
</tr>
<tr>
<td>Alimony paid during nonresidency period</td>
<td>$6,000</td>
</tr>
<tr>
<td>California AGI*</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total AGI*</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

\[
\text{Alimony deduction allowed for nonresidency period} = \frac{\text{California AGI} \times 25\%}{\text{Total AGI}} = \frac{100,000 \times 25\%}{400,000} = 1,500
\]

\[
\text{Total alimony deduction} = 1,500 + 6,000 = 7,500
\]

\[
\text{Total alimony deduction} = 9,900
\]

\[
\text{Without regard to the alimony deduction}
\]

**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](https://www.ca.gov) and [R&TC Section 17276](https://www.ca.gov), which conform to [Internal Revenue Code Section 172](https://www.irs.gov).

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)](https://www.ca.gov) 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:** For taxable years beginning in 2002 and 2003, California suspended NOL deductions. Taxpayers may continue to compute and carryover an NOL during the suspension period.

For taxable years beginning in 2008 and 2009, California suspended NOL carryover deductions with the exception of individual taxpayers with net business income of less than $500,000. Taxpayers may continue to compute and carryover an NOL during the suspension period.

For taxable years beginning in 2010 and 2011, California suspended NOL carryover deductions with the exception of individual taxpayers with modified adjusted gross income of less than $300,000. Taxpayers may continue to compute and carryover an NOL during the suspension period.

**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

<table>
<thead>
<tr>
<th></th>
<th>Total Taxable Income</th>
<th>CA Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>NV business</td>
<td>$ 9,000</td>
<td></td>
</tr>
<tr>
<td>CA business</td>
<td>(3,000)</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$ 6,000</td>
<td>$ (3,000)</td>
</tr>
</tbody>
</table>

**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.

### Example 2

**Taxable Years 2008 - 2010**

Assume the same facts as Example 1. For taxable years 2003 through 2007 David has no income or loss from his California or Nevada business. In taxable year 2008 through 2010 he only has income and loss from each business as follows:

#### Taxable Year 2008:

<table>
<thead>
<tr>
<th></th>
<th>Total Taxable Income</th>
<th>CA Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>NV business</td>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td>CA business</td>
<td>$1,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$151,000</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

#### Taxable Year 2009:

<table>
<thead>
<tr>
<th></th>
<th>Total Taxable Income</th>
<th>CA Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>NV business</td>
<td>$500,000</td>
<td></td>
</tr>
<tr>
<td>CA business</td>
<td>$(200,000)</td>
<td>$(200,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$(200,000)</td>
<td>$(200,000)</td>
</tr>
</tbody>
</table>

#### Taxable Year 2010:

<table>
<thead>
<tr>
<th></th>
<th>Total Taxable Income</th>
<th>CA Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>NV business</td>
<td>$375,000</td>
<td>$ 100,000</td>
</tr>
<tr>
<td>CA business</td>
<td>$ 100,000</td>
<td>$ 100,000</td>
</tr>
<tr>
<td>Total</td>
<td>$465,000</td>
<td></td>
</tr>
</tbody>
</table>

**Determination**

**Taxable Year 2008:** Only your business income from California sources is used in determining the exception to the NOL suspension. Your California source income of $1,000 does not exceed $500,000 of net business income. Therefore, you are allowed an NOL carryover deduction. Your carryover of $1,800 from taxable year 2002 is partially absorbed in 2008 against your California source business income of
$1,000. You can carry the remaining $800 to future years until it expires or is absorbed.

**Taxable Year 2009:** Although you produced net business income from all sources, your California source business income resulted in a NOL. Your net loss of $200,000 will be combined with your previous loss carryover of $800. These amounts will be carried to future years until expired or absorbed.

**Taxable Year 2010:** In this example, business income is equal to modified adjusted gross income. Since modified adjusted gross income exceeds $300,000, you are subject to the suspension and are not allowed an NOL carryover deduction. The remaining $200,800 may be carried over to future years until expired or absorbed.

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

If a taxpayer changes residency to California and has NOL carryovers, they need to restate their carryover amounts as if they were a resident of California for all prior years.

**Example 3**

Greta became a California resident on January 1, 2010, moving from Texas. She started a business in Texas in 2003 and opened a different business located in California in 2004. She had no income or loss from either business in 2004 through 2007. Under California law, the income and loss from each business are as follows:

<table>
<thead>
<tr>
<th>Business Location</th>
<th>2003</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>$250,000</td>
<td>$(25,000)</td>
<td>$15,000</td>
<td></td>
</tr>
<tr>
<td>Texas</td>
<td>$(125,000)</td>
<td>$300,000</td>
<td>$50,000</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

**Determination:**

**Step 1**

First restate Greta’s NOL carryovers for prior years as if she was a California resident:

<table>
<thead>
<tr>
<th>2003 Restatement</th>
<th>Total Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003 NOL</td>
<td>$(125,000)</td>
</tr>
<tr>
<td>Allowable Percentage</td>
<td>x 60%</td>
</tr>
<tr>
<td>NOL carryover to 2003</td>
<td>$(75,000)</td>
</tr>
</tbody>
</table>

**2008 Restatement:**

Business Income $550,000
Prior NOL carryover  $(75,000)

*Net business income exceeds $500,000. Greta’s NOL carryover deduction is suspended*

### 2009 Restatement:

<table>
<thead>
<tr>
<th>Total Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Income</td>
</tr>
<tr>
<td>Prior NOL carryover</td>
</tr>
<tr>
<td>NOL carryover to 2010</td>
</tr>
</tbody>
</table>

### Step 2

Combine Greta’s business income from all sources to determine her NOL carryover to 2011.

<table>
<thead>
<tr>
<th>Total Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA source income</td>
</tr>
<tr>
<td>TX source income</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Prior year NOL carryover</td>
</tr>
<tr>
<td>NOL carryover to 201</td>
</tr>
</tbody>
</table>

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

If a taxpayer changes residency from California and has NOL carryovers, they need to restate their carryover amounts as if they were a nonresident of California for all prior years.

**Example 4**

Assume the same facts as Example 3. Greta became a nonresident of California on January 1, 2011. Her Texas and California businesses earn income of $3,000 and $4,000 respectively.

**Determination**

Restate your NOL carryover as if you had been a nonresident of California for all prior years by netting business income and losses from California sources only.

### 2003 Restatement

<table>
<thead>
<tr>
<th>Total Taxable Income</th>
<th>CA Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Texas source business loss</td>
<td>$(125,000)</td>
</tr>
<tr>
<td>CA NOL allowed percentage,</td>
<td>x 60%</td>
</tr>
</tbody>
</table>

---

*Note: The example and calculation are illustrative and for educational purposes.*
| NOL carryover to 2004 | $(75,000) | $0 |

<table>
<thead>
<tr>
<th>2008 Restatement</th>
<th>Total Taxable Income</th>
<th>CA Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>TX source business income</td>
<td>$300,000</td>
<td></td>
</tr>
<tr>
<td>CA source business income</td>
<td>$250,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Total</td>
<td>$550,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Prior year NOL carryover</td>
<td>$(75,000)</td>
<td>$0</td>
</tr>
</tbody>
</table>

You cannot use your NOL carryover in determining total taxable income because your net business income exceeds $500,000. You do not have a California source NOL to carryover for California taxable income.

<table>
<thead>
<tr>
<th>2009 Restatement</th>
<th>Total Taxable Income</th>
<th>CA Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>TX source business income</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>CA source business income</td>
<td>$(25,000)</td>
<td>$(25,000)</td>
</tr>
<tr>
<td>Total</td>
<td>25,000</td>
<td>$(25,000)</td>
</tr>
<tr>
<td>Prior year NOL carryover</td>
<td>$(75,000)</td>
<td>$0</td>
</tr>
<tr>
<td>Carryover to 2010</td>
<td>$(50,000)</td>
<td>$(25,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2010 Restatement</th>
<th>Total Taxable Income</th>
<th>CA Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>TX source business income</td>
<td>$5,000</td>
<td></td>
</tr>
<tr>
<td>CA source business loss</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Total</td>
<td>20,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Prior year NOL carryover</td>
<td>$(50,000)</td>
<td>$(25,000)</td>
</tr>
<tr>
<td>Carryover to 2011</td>
<td>$(30,000)</td>
<td>$(10,000)</td>
</tr>
</tbody>
</table>

Part-Year Resident

If a taxpayer changes residency during the year, compute their NOL deduction using resident rules for the period of the year they were a California resident and nonresident rules for the period of the year they were a nonresident. Compute any NOL carryovers as if the taxpayer were a California resident for all prior years and as if they 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 5

Henry moved to California on May 1, 2010. His total and California source income and losses from Washington and California business operations for 2010 were as follows:

<table>
<thead>
<tr>
<th>Before May 1, 2010</th>
<th>After May 1, 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>WA business</td>
<td>$14,000</td>
</tr>
<tr>
<td>CA business</td>
<td>$(2,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

Henry's NOL carryover from prior years is $6,000 as if he were a resident for all prior years and $3,000 as if he were a nonresident for all prior years.

Determination:

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:

**Step 1:**
- CA business losses, before May 1, 2010: $(2,000)
- Total business losses, after May 1, 2010: $(16,000)
- Total: $(18,000)
- Current year NOL, 2004: $(18,000)

**Step 2:**
- Prorate Henry's NOL carryover amounts based upon periods of California residency and nonresidency during 2010.

<table>
<thead>
<tr>
<th>Period of Residency</th>
<th>Period of Nonresidency</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOL carryover, as if a CA resident for all prior years: $(6,000)</td>
<td>NOL carryover, as if a CA nonresident for all prior years: $(3,000)</td>
</tr>
<tr>
<td>CA resident days ÷ total days 245 ÷ 365 x .6712</td>
<td>Nonresident days ÷ total days 120 ÷ 365 x .3288</td>
</tr>
<tr>
<td>Prorated NOL carryover: $(4,207)</td>
<td>Prorated NOL carryover: $(986)</td>
</tr>
</tbody>
</table>

Compute your prior year NOL carryover:

| NOL Carryover from prior years, resident period | $(4,027) |
| NOL carryover from prior years, nonresident period | $(986) |
| Total NOL carryover from 2010 | $(5,013) |

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:

\[ \text{CA alternative minimum tax} = \text{CA tentative minimum tax} - \text{Prorated regular tax} \]

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
- Total alternative minimum taxable income: 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 x .7200
- Total alternative minimum tax adjusted gross income: 250,000

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) x .0506
- Total alternative minimum taxable income: 235,000
- 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:

<table>
<thead>
<tr>
<th>Taxable year 2002:</th>
<th>Total taxable income</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA rental income</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>CA rental losses</td>
<td>(30,000)</td>
<td>(30,000)</td>
</tr>
<tr>
<td>TX rental income</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$(24,000)</td>
<td>$(28,000)</td>
</tr>
<tr>
<td>Allowed rental losses</td>
<td>24,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Suspended loss to 2003</td>
<td>$0</td>
<td>$(3,000)</td>
</tr>
</tbody>
</table>

**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:

<table>
<thead>
<tr>
<th>Taxable year 2002</th>
<th>Total taxable income</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Total taxable income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2002 Restatement:</strong></td>
<td></td>
</tr>
<tr>
<td>CA partnership income</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>CA S corporation loss</td>
<td>(8,000)</td>
</tr>
<tr>
<td>NY partnership income</td>
<td>3,000</td>
</tr>
<tr>
<td>Suspended loss to 2003</td>
<td>$(3,000)</td>
</tr>
</tbody>
</table>

Step 2

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

<table>
<thead>
<tr>
<th>Total taxable income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Taxable year 2003</strong></td>
<td></td>
</tr>
<tr>
<td>CA partnership income</td>
<td>$ 3,000</td>
</tr>
<tr>
<td>CA S corporation loss</td>
<td>(1,000)</td>
</tr>
<tr>
<td>NY partnership income</td>
<td>7,000</td>
</tr>
<tr>
<td>Total</td>
<td>$ 9,000</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>2002 Restatement:</th>
<th>Total taxable income</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA partnership income</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>CA S corporation loss</td>
<td>(8,000)</td>
<td>(8,000)</td>
</tr>
<tr>
<td>NY partnership income</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Suspended passive loss to 2003</td>
<td>$(3,000)</td>
<td>$(6,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2003 Restatement:</th>
<th>Total taxable income</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA partnership income</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>CA S corporation loss</td>
<td>(1,000)</td>
<td>(1,000)</td>
</tr>
<tr>
<td>NY partnership income</td>
<td>7,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$9,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Suspended loss from 2002</td>
<td>(3,000)</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Income or suspended loss, 2003</td>
<td>$6,000</td>
<td>$(4,000)</td>
</tr>
</tbody>
</table>

**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.
## 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:

<table>
<thead>
<tr>
<th>Before October 1, 2002</th>
<th>After October 1, 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total passive income</td>
<td>$13,500</td>
</tr>
<tr>
<td>CA passive income</td>
<td>7,500</td>
</tr>
<tr>
<td>Total passive losses</td>
<td>$(3,000)</td>
</tr>
<tr>
<td>CA passive losses</td>
<td>$(6,000)</td>
</tr>
<tr>
<td>CA passive income</td>
<td>2,500</td>
</tr>
<tr>
<td>Total passive losses</td>
<td>$(1,000)</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total passive income, before October 1, 2002</td>
<td>$13,500</td>
</tr>
<tr>
<td>Total passive losses, before October 1, 2002</td>
<td>$(3,000)</td>
</tr>
<tr>
<td>CA passive income, after October 1, 2002</td>
<td>2,500</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Period of Residency</th>
<th>Period of Nonresidency</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001 suspended loss, as if a CA resident for all prior years</td>
<td>$7,000</td>
</tr>
<tr>
<td>CA resident days ÷ total days</td>
<td>273 ÷ 365</td>
</tr>
<tr>
<td>Prorated 2001 suspended loss</td>
<td>$5,235</td>
</tr>
</tbody>
</table>

Step 3

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

<table>
<thead>
<tr>
<th>Taxable year 2002:</th>
<th>CA taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Passive income before suspended losses</td>
<td>$11,000</td>
</tr>
<tr>
<td>Suspended passive loss, resident period</td>
<td>(5,235)</td>
</tr>
<tr>
<td>Passive loss, nonresident period</td>
<td>(1,260)</td>
</tr>
<tr>
<td>Passive income, 2002</td>
<td>$4,505</td>
</tr>
</tbody>
</table>

3850 Other State Tax Credit

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 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 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.

3900 Professional Athletes

RSTM 3910  Duty Day Allocations
RSTM 3920  Playing vs. Signing Bonuses
RSTM 3930  Endorsement Income

3910 Duty Day Allocations

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.

Many appeals have been heard on allocating professional athletes' income. In the Appeal of Joseph Barry Carroll, 87-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. This includes all days on which a player practices, travels, or plays during the season. The California Court of Appeals (Court) affirmed this method in Marc D. Wilson et al. v FTB, 20 Cal. App. 4th 1441 (1993).

The duty day allocation ratio is:

| CA Duty Days | Total Duty Days |

This ratio applies to all active team members, coaches, managers, and trainers.

3920 Playing vs. Signing Bonuses

In addition to a player's salary, bonuses may be apportioned under the duty days formula depending upon how they are characterized. A true "signing bonus" does not represent compensation for services,
but is consideration for the signing of the contract and the player’s promise not to play for another team; it is allocated in its entirety to the state of the player’s residence rather than being apportioned under the duty days formula and is considered an intangible property right (Appeal of George and Sheila Foster, 84-SBE-159, Nov. 14, 19841). By contrast, a “playing bonus” represents compensation for services rendered during the season, and is apportionable under the duty days formula.

If the contract includes language where the player is obligated to repay a proportionate share of the bonus for any period of time in which they fail or refuse to practice or play (i.e. refundable), then the bonus must be apportioned under the duty days formula. If the player has the right to refuse to perform yet still keep the bonus (i.e. nonrefundable), then it is not compensation for services and should not be apportioned under the duty days formula (Appeals of Garrison Hearst & Antonio Langham, 02-SBE-007, Nov. 13, 2002).

California Regulation 17952 (d) indicates the source of gains and losses from intangible personal property is determined at the time of the sale or transfer of the 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). Thus, a true “signing bonus” (and all subsequent payments) would have a source in the player’s state of residence at the time of the sale or transfer of the intangible personal property.

3930 Endorsement Income

If by contract an athlete is required to perform services in California on behalf of a sponsor, the payments received on the contract are generally considered to be California source income.

For example, where a contract requires an athlete to appear at a California event wearing the sponsor’s clothing, bearing its logo, or using the sponsor’s equipment, that athlete has performed a service on behalf of the sponsor at that California event.

California source income to nonresident athletes at a California event may include, but are not limited to payments for:

- Wearing or using sponsor’s product.
- Making promotional appearances.
- Participating in photo and filming days.
- Combinations thereof, in connection with the advertisement, promotion, and sale of products.
4000 RESIDENCY AND SOURCING AUDIT GUIDELINES

**RSTM 4100**  Tax Forms and Reference Publications

**RSTM 4200**  Identifying Residency and Sourcing Cases

**RSTM 4300**  Pre-Audit Analysis

**RSTM 4310**  Scoping Returns

**RSTM 4320**  Skip Tracing

**RSTM 4330**  Reviewing Prior Audits

**RSTM 4340**  Gathering Related Entity Tax Returns

**RSTM 4350**  Researching Tax and Case Law

**RSTM 4360**  Evaluating Case Materiality

**RSTM 4400**  Opening the Audit

**RSTM 4410**  Overview of the Residency Audit Issue

**RSTM 4420**  Setting Up Audit Workpapers

**RSTM 4430**  Residency Audit Issue Section (AIS)

**RSTM 4440**  Identifying What Preliminary Information is Needed

**RSTM 4450**  Initial Contact Letter

**RSTM 4460**  Audit Discussion

**RSTM 4500**  The Ongoing Audit

**RSTM 4510**  Gathering Relevant Information

**RSTM 4520**  Responses to Information Document Requests

**RSTM 4530**  Third-Party Contacts

**RSTM 4540**  Subpoenas

**RSTM 4550**  Affidavits and Declarations
Residents with a filing requirement must file Form 540, 540A, or 540 2EZ. Nonresidents and part-year residents with a filing requirement must file Form 540NR.

R&TC Section 18521(a) states that individuals must use the same filing status as on their federal tax return.

R&TC Section 18521(c) states that a nonresident joint return must be filed if one spouse or registered domestic partner (RDP) was a resident for the entire year and the other spouse or RDP was a nonresident for all or part of the year. According to R&TC Section 18521(C)(1) & (C)(2), this rule does not apply if:

- Either spouse was an active member of the United States armed forces.
• Either spouse was a nonresident for the entire year and had no income from California sources during the year.

If either exception applies, the couple may file jointly or separately.

Reference Publications

Taxpayers can refer to the following publications to help them make an accurate determination of their residency status and to identify which types of income are taxable by California:

• Pub 1031 - Guidelines for Determining Resident Status
• Pub 1032 - Tax Information for Military Personnel

For taxable years 1987 through 2001, nonresidents and part-year residents compute their tax as if they were residents for the entire year. They then multiply this amount by the ratio of California adjusted gross income over total adjusted gross income to determine their tax liability.

For taxable years beginning January 1, 2002, AB 1115 changed the method for computing the tax of nonresidents and part-year residents. Taxpayers compute the tax by multiplying the “taxable income of a nonresident or part-year resident,” by a rate (expressed as a percentage) equal to the tax computed on the entire taxable income of the nonresident or part-year resident as if the nonresident or part-year resident were a resident of this state for the taxable year and as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by the amount of that income.

The following publication gives you information about the new tax computation method and the calculation of loss carryovers, deferred deductions, and deferred income of nonresidents and part-year residents.

• Pub 1100 – Taxation of Nonresidents and Individuals Who Change Residency

The following publication gives you information about the taxation of the various types of stock options and what stock option income is taxable by California:

• Pub 1004 – Stock Option Guidelines

4200 Identifying Residency and Sourcing Cases

Residency Cases

We use various criteria to select potential residency cases. We identify most residency cases by the taxpayer filing Form 540NR. Our residency cases also originate from the following areas:

• Claims for refund.
• Discovery projects.
• Other program and departmental referrals.
• Informant cases.
• Special Investigation referrals.
• Filing enforcement referrals.
• Law enforcement and other agency referrals.
• Revenue Agent Reports. (RARs)

**Sourcing Cases**
We identify most sourcing cases when the taxpayer reports a change of residency status on Form 540NR. Our sourcing cases also originate from the following areas:

- Claims for refund.
- Discovery projects.
- Other program and departmental referrals.

**4300 Pre-Audit Analysis**

You conduct a pre-audit analysis to form the basis for your decision to proceed with the audit or accept the return as filed. If you proceed with the audit, you must also plan the audit and perform preliminary work. You must give proper attention to the pre-audit procedures in order to improve the quality of your audit and help reduce your total audit time.

Use the pre-audit steps discussed below for all residency examinations. Once you identify specific audit issues, you may expand the pre-audit steps to specifically address those issues. Tailor the pre-audit steps for sourcing cases.

Pre-audit analysis consists of:

- **RSTM 4310** Scoping Returns
- **RSTM 4320** Skip Tracing
- **RSTM 4330** Reviewing Prior Audits
- **RSTM 4340** Gathering Related Entities’ Tax Returns
- **RSTM 4350** Researching Tax and Case Law
- **RSTM 4360** Evaluating Case Materiality

**4310 Scoping Returns**

Review all parts of the return in detail to make a preliminary identification of any audit issues. Ensure you obtain all amended returns for the taxable years under potential audit.

Keep in mind the following issues in addition to determining whether or not the taxpayer is a resident of California.

- Determine the actual date the taxpayer became a resident since residents must report all income from all sources.
- Determine what portion of a nonresident's income is from a California source for those taxpayers leaving California.
• Determine the date when income realization occurred. Did income realization occur before the taxpayer became a resident, while he was a resident, or after he terminated his resident status?

As you review the returns, take preliminary notes to record any questions or potential audit issues. Resolve many of the questions contained in your notes as you progress through the pre-audit process. Incorporate any remaining questions into your examination process.

Review the prior and subsequent years' tax returns. For residency cases, you gain a better understanding of the taxpayer's connections. For sourcing cases, adjustments made in the examination year could also apply to other years.

**When scoping a tax return for the residency issue, note the following information disclosed on the tax return:**

- Responses to the residency questions contained on Schedule CA (540NR).
- Address on the return.
- Address on the W-2s and 1099s.
- State tax information on the W-2s.
- Other addresses disclosed on the return.
- Employer's address.
- Address of tax preparer.
- Social security number of taxpayer, spouse, and dependents.
- Federal identification numbers of partnerships, S corporations, and LLCs.
- Location of assets that were sold or exchanged.
- Location of rentals and other investments.
- Location of banks and financial institutions.
- Location of farms on Schedule F.
- Taxpayer's occupation.
- Moving expense information (including reimbursement on W-2).
- Large income from intangibles.
- Income, expenses, and deductions which may indicate connections within and without California.
- Schedule C activity and address.
- Investment activity (determine whether the taxpayer maintains a passive or active role in the activity).
- Closely held corporations.
- Other state tax credit.
- Other audit issues.

If you encounter any unfamiliar issues on the return, do preliminary research to gain an awareness of the issue. Researching all issues during the pre-audit stage assists you in planning the audit.

**4320 Skip Tracing**

Skip tracing involves the gathering of preliminary information. Skip tracing information is generally submitted with the case for your review. This information assists you in familiarizing yourself with the taxpayer's connections and helps in your decision whether or not to open the case.
We get skip tracing information from both internal and external resources. Some of the sources used to obtain preliminary information include:

- Departmental video files.
- DMV records.
- Internet.
- Lexis/Nexis.
- Prior audit reports.

Obtain driver's license, vehicle registration, voter's registration, and property assessor information by contacting government and local authorities within and without California on a case-by-case basis. Lexis/Nexis provides some of this information.

The Internet contains a wealth of information, including news articles, business information, and possibly taxpayer profiles and historical information. Depending on the site, interpret the Internet information cautiously and corroborate with additional documents whenever possible.

4330 Reviewing Prior Audits

Conduct a review of prior audit reports, protests, and appeal files during the pre-audit phase. These documents help you identify relevant facts that may apply to the current year and also help you determine the extent of the audit scope.

Prior audit reports help streamline the current audit process and avoid duplication of efforts between both audit cycles. However, do not base your audit solely upon facts developed in a prior audit cycle without adequate factual development for the current period. Use judgment in determining the degree of additional information you need for your audit years.

Once you determine the amount of reliance to place on facts developed in the prior audit, you must then determine the amount of additional information you need for the current audit cycle.

4340 Gathering Related Entities' Tax Returns

Review any related entity tax returns during the pre-audit phase. While scoping a taxpayer’s return or the skip tracing information, you may find the taxpayer’s corporation or partnership interests. Request and review the returns of the related entities in order to obtain possible taxpayer connections.

4350 Researching Tax and Case Law

Residency and sourcing research resources include:

- R&TC.
- California Administrative Code. (Regulations)
- BOE decisions.
- Court Cases.
- Legal Rulings.
Include a thorough research of tax and case law during your pre-audit analysis. Read BOE cases involving similar facts to help you:

- Better understand the issues.
- Determine what records and information you need.
- Determine what information to request.

### 4360 Evaluating Case Materiality

After analyzing a sufficient amount of information and evaluating the merits of the case, consider:

- Whether the information gathered supports opening the case.
- Whether the taxpayer retained significant ties to the claimed state of residence.
- Whether the taxpayer severed significant ties to California.
- Other state tax credits.

Do not open cases with limited materiality. Make your decision to survey a case as important as your decision to open a case. Seek guidance from your supervisor or manager, if necessary.

### 4400 Opening the Audit

Once you decide to open an audit, you must plan the audit. This section includes:

- **RSTM 4410** Overview of the Residency Audit Issue
- **RSTM 4420** Setting Up Audit Workpapers
- **RSTM 4430** Residency Audit Issue Section (AIS)
- **RSTM 4440** Identifying What Preliminary information is Needed
- **RSTM 4450** Initial Contact Letter
- **RSTM 4460** Audit Discussion

### 4410 Overview of the Residency Audit Issue

Residency examinations are very fact intensive. You find unique facts and circumstances in each case and the relevance or weight you attach to a particular fact varies in each case. This environment poses several challenges for you.

Obtain a good overall understanding of the preliminary information. This way, you tailor your information requests to the specific taxpayer. Be prepared to present all of the relevant facts. The importance you give to particular facts must be put into perspective when viewed in conjunction with the overall activities of
the taxpayer. Therefore, present a complete, comprehensive, accurate, and objective picture in your position letter.

4420 Setting Up Audit Workpapers

Set up the workpapers very early in the audit process and cross-reference as you add information to your file. You save a lot of time looking for documents if you cross-reference. You also achieve a better-organized file with an easy to follow audit trail.

In addition to saving you time looking for documents, adequate cross-referencing:

- Allows other users to quickly find the documents used to support your determination.
- Reduces the difficulty in locating or discovering information in the file.
- Provides an understanding of the purpose or significance of the documents.

Keep all responses, including attachments, intact and place the entire reply in the Correspondence Section of your workpapers. This allows you and other users to see what documents you received within that specific reply.

With the exception of cross-referencing, never write on original documents received from taxpayers, representatives, or third parties. If you need to include information on a particular original document, write explanatory notes on a separate page and attach the page to the document. Alternatively, make notes on copies of the original documents. Reference both the original and the copy to inform readers that both documents exist. Include copies of all documentation relevant to the audit issues in the audit file.

4430 Residency Audit Issue Section (AIS)

The Residency AIS follows the IFLAC (Issue, Facts, Law, Analysis, Conclusion) format. Making a residency determination depends on the facts and circumstances of each particular case. Therefore, the Residency AIS will reflect the relevant facts and circumstances of each particular audit. Facts must be gathered regarding a taxpayer’s California connections and the taxpayer’s claimed state connections. A brief discussion of the types of facts generally included in a Residency AIS follows:

**Tax Return Filings**

**California:**

- Filing history.
- Mailing address on tax return, if relevant.
- Table reflecting total taxable income and California source income for relevant years.
- Information reported on Part I of Schedule CA (NR) for each tax year under audit.

**Claimed State:**

- Mailing address on tax return, if relevant.
• Table reflecting the amount of income taxed by the claimed state and the taxes paid to the claimed state. If the claimed state does not impose a personal income tax, state so.

Other States:
• Information reported on other state tax returns, if relevant.

Federal:
• Table reflecting a breakdown of income components reported for the tax years under audit.

Personal Residences
For each personal residence located in California, the claimed state, or elsewhere that the taxpayer occupied during the years under audit, include:

• Purchase price, date of purchase, and assessed value.
• Brief description of the residence.
• Homeowner’s/Renter’s insurance policy.
• Furnishings/shipment of household goods.
• Homeowner’s property tax exemption information.
• Dates of occupancy.

Personal Transportation
For each vehicle owned and registered by the taxpayer in California, the claimed state, or elsewhere (if relevant) during the years under audit, include:

• Make and model of the vehicle.
• Dates of ownership.
• States of registration.
• Table reflecting vehicle expenses paid by the taxpayer, the date of payment, and the location of the payee. (Information obtained from financial database.)

Pets
For any pets owned by the taxpayer during the years under audit, include:

• Type of pet.
• Location of pet.
• Listing reflecting the pet expenses paid by the taxpayers. Include the payee name, payee location, and the date of payment. (Information obtained from financial database.)

Businesses
For each relevant business activity engaged in by the taxpayer during the years under audit, include:
• Business name and address.
• Type of business.
• Nature of the taxpayer’s involvement in the activity.

**Employment**
For each company the taxpayer worked for during the years under audit, include:

• Business name and address.
• Type of business.
• Nature of the taxpayer’s duties.
• Compensation received from the company.
• Locations where the taxpayer performed services for the company.

**Voter Registration**
For each state the taxpayer was registered to vote in during the years under audit, include:

• Date taxpayer registered to vote.
• Voting history.
• Status of voter registration.

**Driver’s License**
For each state the taxpayer maintained a valid driver’s license during the years under audit, include:

• Registration period.
• Residence address listed on the license.
• Status of driver’s license.

**Bank Accounts**
For each bank account maintained by the taxpayer during the years under audit, include:

• Bank name and account number.
• Type of account.
• Branch location.
• Date account opened and closed, if applicable.
• Authorized signatories.
• Table reflecting transaction activity locations. (Information obtained from financial database.)

**Credit Cards**
For each credit card maintained by the taxpayer during the years under audit, include:

• Credit card name and account number.
• Date account opened and closed, if applicable.
• Authorized signatories.
• Combine all credit card transactions into one table reflecting transaction activity locations. (Information obtained from financial database.)

**Family**
For any family members deemed relevant to the examination, include:

• Name and relationship to the taxpayer.
• Age, if a minor child, during the years under audit.
• Location of the family member during the years under audit.

**Memberships**
For each club, located in California, the claimed state, or elsewhere (if relevant) to which the taxpayer maintained a membership during the years under examination, include:

• Name and address of the club.
• Type of club.
• Dates of membership.

**Organizations**
For each organization to which the taxpayer belonged in California and the claimed state during the years under examination, include:

• Name and address of the organization.
• Type of club.
• Dates of membership.
• Nature of the taxpayer's involvement with the organization.

**Professionals**
For each medical, legal, accounting, or other professional relevant to the audit period, include:

• Professional's name and address.
• Listing of the payment dates. (Information obtained from financial database.)

**Physical Presence**

• The date the taxpayer reported their residency changed.
• Calendars reflecting the physical presence of the taxpayer for each year under audit. (Information obtained from financial database plus any other documents gathered during the examination which identify physical presence.)
• An explanatory paragraph regarding the interpretation of the calendars.
Law
Include:

- California tax code and regulations.
- California case law on domicile and residency.

Analysis of Facts
Analyze each of the facts sections separately. Objectively evaluate how each section of facts affects the taxpayer’s residency status. This analysis will provide support for the final determination of the audit.

Audit Determination
Include:

- Audit determination regarding the taxpayer’s domicile.
- Audit determination regarding the taxpayer’s residency status.

Conclusion
Briefly state the conclusion reached based upon the audit determination.

Taxpayer’s Position
Include relevant facts, tax authority, and the basis for the taxpayer’s disagreement with the audit determination.

Rebuttal to Taxpayer’s Position
Address all areas of disagreement set forth in the taxpayer’s response to the audit determination.

4440 Identifying What Preliminary Information is Needed
Since taxpayer circumstances vary, the information and frequency of items requested varies. Causes for the variance include:

- The number of years at issue.
- The complexity of the taxpayer.
- The type and quantity of connections held within and without California.
- The presence of California source income.
- The completeness of information and records submitted.

4450 Initial Contact Letter
The Initial Contact Letter (ICL) establishes and communicates your purpose for contacting the taxpayer. Use the following PASS Templates and enclosures for your cases:
Because you request only audit representation information in the residency Initial Contact Letter, use a 10-day "reply by" date. Use a 30-day "reply by" date for sourcing Initial Contact Letters.

**4460 Audit Discussion**

For residency audits, contact the representative designated in the taxpayer's response to your Initial Contact Letter before sending out your Information Document Request. Include the following information when you contact the representative:

- Briefly, discuss the residency audit issue and any other issues under audit.
- Explain the type of information requested in residency audits.
- Explain that there is a 30-day turn-around time frame for responses to IDRs and for your responses to the representative.

**4500 The Ongoing Audit**

The ongoing audit process includes the following sections:

- **RSTM 4510** Gathering Relevant Information
- **RSTM 4520** Responses to Information Document Requests
- **RSTM 4530** Third-Party Contacts
- **RSTM 4540** Subpoenas
- **RSTM 4550** Affidavits and Declarations
- **RSTM 4560** Financial Records
- **RSTM 4570** Physical Presence
- **RSTM 4580** Documenting the Audit

**4510 Gathering Relevant Information**
You identify, gather, and evaluate relevant information continually during your audit. You request relevant documents, records, and information from taxpayers and their representatives using the Information Document Request. Consider alternative documentation as a suitable replacement if the primary documents are unavailable or too costly to obtain. However, evaluate alternative documentation on a case-by-case basis.

When identifying and gathering the information needed, use the following guidelines:

- Request only relevant documents.
- Prepare written requests using the Information Document Request.
- Make a reasonable inquiry, evaluate the data, and then ask for additional information, as necessary.
- Update the GTA Document Index when you receive the documents.
- Assess the need to follow-up on documents requested but not provided in response to your Information Document Requests.
- Organize the documents you receive in your audit file.
- For unavailable information, propose alternative sources of information, verify data through independent sources, and offer your assistance in retrieving records on behalf of the taxpayer.
- Ask the taxpayer and representative to clarify any apparent discrepancies.
- Maintain a positive working relationship with the taxpayer and representative.

Occasionally, taxpayers and representatives allow you to look at documents in their offices but refuse to allow you to photocopy the documents or to provide you with photocopies. R&TC Section 19504 entitles you to photocopy documents. If you encounter any obstacles, contact your supervisor or manager for guidance.

**4520 Responses to Information Document Requests**

Make every effort to obtain the information necessary to conduct the audit and support your conclusions and recommendations. Clearly communicate the need and relevance of the information to the taxpayer or representative.

If the taxpayer indicates that he does not possess the information, but the information exists, consider preparing a letter for the taxpayer to sign authorizing the Franchise Tax Board to obtain the information on the taxpayer’s behalf. Use the FTB Form 2590 *Authorization to Release Financial Information* for requests to financial institutions.

If the taxpayer is unable to provide information you request, the taxpayer should be able to explain the procedures used to locate the information. Consider using the following note in your IDRs:

**Note:** If the requested information could not be located, please provide a description of the search procedures used in the attempt to locate this information. If the requested information was located but was not provided due to a claim of privilege, please provide a privilege log for the documents withheld, including the nature of the privilege claimed, and the names, titles, and roles of all individuals who prepared or received the documents (including cc's and bcc's).
Sometimes taxpayers provide only partial responses, which do not satisfy the Information Document Requests. If you determine that the taxpayer's lack of cooperation hinders your ability to make a correct audit determination, then decide whether to issue a demand letter.

Document the taxpayer's or representative's responses in case the need for demand letters, subpoenas, or penalties arises. Document the reasons why you needed the information requested in order to make a proper audit determination.

Regularly monitor the outstanding items of each Information Document Request so you can issue timely demands or subpoenas. The taxpayer's partial furnishing of some of the information requested does not preclude the department from issuing demand letters and ultimately a failure to furnish penalty with respect to the remaining information. Review the MAP for more guidance.

**4530 Third-Party Contacts**

Taxpayers or their representatives generally furnish you with the information during the audit. However, contact third-parties when necessary to develop the facts of your case.

The factors for contacting a third-party include:

- The taxpayer does not possess the information.
- No alternative sources provide the information.
- No support of facts provided by the taxpayer or representative.
- The third-party possesses the original source of records or facts.
- Despite requests, the taxpayer does not submit the requested information or provide authorization to contact the third-party.

**R&TC Section 19504** authorizes the department to request and obtain information from third-parties. You must provide notice to all taxpayers prior to contacting third-parties (Taxpayer Bill of Rights Act of 1999). Accordingly, notify the taxpayer before contacting the third-party and give the taxpayer the opportunity to provide alternative sources of information (**R&TC Section 19504.7**). Review the MAP for further information regarding third-party contact policy and procedures.

Apply the following guidelines when obtaining information from third-parties:

- Make the response as easy as possible. When appropriate, suggest the third-party respond by making marginal notations on a copy of the request letter enclosed with the original.
- Get the third-party to provide the information in writing whenever possible.
- If the third-party furnishes the information verbally over the telephone, then request the third-party confirm the information in writing. If no confirmation in writing is provided, then document the call as support for the information obtained.

**4540 Subpoenas**

If you are still unable to obtain the information from third-parties, use a subpoena duces tecum. Also, use a subpoena duces tecum to reduce the fees imposed by certain financial institutions. Check with your
supervisor before issuing a subpoena. See the Subpoena Manual for instructions and procedures for issuing a subpoena duces tecum.

4550 Affidavits and Declarations

During the course of the audit, taxpayers can provide affidavits (sworn statements) and declarations (unsworn statements) from third-parties to help us understand their particular situation. Both types of documents are admissible as evidence in a legal transaction.

Affidavits and declarations are most helpful when they properly substantiate the facts and events in question. Verify the information contained in the affidavits and declarations with the facts gathered during the examination. A standardized declaration form, FTB 2153 C1 PC Declaration Form, greatly simplifies the third-party verification process for taxpayers.

4560 Financial Records

Financial records include the most useful, but most sensitive, documents obtained during a residency audit. Monthly bank statements, canceled checks, credit card statements, and credit card receipts provide valuable information regarding the taxpayer’s physical presence and extent of financial activities. Identify financial accounts by reviewing federal Schedule B and by requesting the information in your Information Document Requests.

Requests

Generally, request information regarding the financial accounts before requesting copies of the actual documents. Include the following information in the request: account numbers, branch locations, authorized signatories and users on each account, type of account, and the date each account was opened and closed. Having this information first, allows you to assess which financial documents you need to obtain.

If the taxpayer cannot furnish the requested financial records, we can attempt to obtain the records directly from the financial institution. You will need to complete the Authorization to Release Financial Information (9920) found in PASS Draft folder and have the taxpayer(s) sign and date.

Some financial institutions charge fees for the records we request. If there is a charge, you should follow the service agreement procedures to obtain authorization prior to formally requesting any financial records.

Confidentiality of Accounts

In order to help maintain confidentiality of taxpayer account information do not include the complete account number in correspondence with the taxpayer or representative. For example XYZ Bank account 12345678 can be identified as XXXX5678.

You may use the full account number in your audit issue section and when requesting financial information from financial institutions.
Information gathered from the following financial documents includes:

**Bank statements**

Dates and locations of deposits, withdrawals, and wire transfers.

Dates and locations of ATM, EFT, POS, and debit transactions.

Location of major funds.

Mailing addresses.

Other financial accounts.

Date account was opened and closed.

**Canceled Checks**

Dates and locations where checks were written.

Other financial accounts (i.e., payments for retail accounts and credit card accounts).

Physical presence.

Names and locations of payees (i.e., locations of doctors, dentists, grocery stores, clubs, veterinarians, salons, dry cleaners, and auto repairs).

Miscellaneous information (the memo area can provide additional information).

Mailing addresses.

**Credit card statements and receipts**

Dates and locations of transactions.

Signed receipts indicating presence.

Locations of personal services utilized (i.e., locations of doctors, dentists, grocery store, clubs veterinarians, salons, dry cleaners, auto repairs, gas purchases, dining).

Mailing addresses.

**Financial Database**

Once you obtain the financials documents, determine whether the documents need to be data based. For documents that require data basing, complete the Database Request Form and submit the financial documents to your supervisor. Audit Support staff perform the data basing function for auditors.
The database provides a spreadsheet of the financial information and incorporates this data into various useful schedules, charts, and graphs. Use these visual representations of the financial data to show the taxpayer's financial activity and physical presence in various locations as follows:

Schedule comparing physical presence in California, the claimed state of residence, and other locations.

Graphs comparing the number of checks written to payees in California, the claimed state of residence, and other locations.

Graphs comparing the total expenditures in California, the claimed state of residence, and other locations.

Graphs comparing the types of expenditures in California, the claimed state of residence, and other locations (i.e., day-to-day expenditures, utility and household expenditures, medical expenditures).

Analyzing financial information

Once you receive the database and financial documents back from Audit Support staff, review the database for accuracy. The responsibility of ensuring the credibility and integrity of the database rests with you.

Use the following guidelines to help you identify the location where a taxpayer wrote a check:

1. Look for handwritten driver's license, credit card, or telephone number information on the front or back of the check. This indicates the payee required identification from the taxpayer at the payee's location when the taxpayer wrote the check.

2. Individuals normally make the following types of expenditures only when present at the payee's location:
   - Grocery stores.
   - Cleaners.
   - Membership stores.
   - Hairstylists/nail care.
   - The type of stores that would not ordinarily bill the taxpayer. (most retail outlets)

3. Individuals normally write and mail checks to payees such as utility companies and mortgage companies. These types of payments generally do not indicate physical presence at the payee's location.

4. Compare the date written by the taxpayer on the front of the check with the check processing date on the back of the check. Determine whether the taxpayer wrote the check in person or mailed the check to the payee.

5. Look for store numbers on the checks. Supermarkets and some department stores may stamp their number on the back of the checks. Use the store number to determine the location of the store.

Account for the financial activity of a husband and wife separately, if necessary, to reflect an accurate representation of each individual's activities.
Although a taxpayer may change his financial account from a California institution to an out-of-state institution, you must analyze and evaluate the substance of the transactions. For example, if the transaction pattern remains the same after the change, determine whether or not to give the change significant weight.

4570 Physical Presence

Perform an independent analysis of the taxpayer's physical presence within and without California by reviewing the taxpayer’s records. In establishing physical presence, use documents that clearly establish the location of the taxpayer. Such documents include credit card statements, receipts, canceled checks, airline tickets, travel expense reports, third-party confirmations, and correspondence. Prepare calendars to reflect a taxpayer’s physical presence for each year under audit.

4580 Documenting the Audit

Due to the large amount of information gathered during a residency examination, you must carefully document the progress of the audit.

One aspect of documenting the audit involves clearly indexing and cross-referencing the information obtained during the audit. Updated and well-organized workpapers ensure:

- The performance of all necessary audit steps.
- The gathering of all material facts.
- The avoidance of duplication of information and effort.
- The examination of all the pertinent supporting documents.
- The explanation of all assumptions.
- The support of your conclusion.
- The documentation of the taxpayer's position.
- The ease of finding information in the audit file.

For further information on the importance of workpaper files, see the MAP.

4600 Making the Audit Determination

Once you gather sufficient documentation, make your audit determination. The following sections will help you in the audit determination process:

- RSTM 4610 Analysis of Facts
- RSTM 4620 Determining Domicile
- RSTM 4630 Determining Residency
- RSTM 4640 Position Letter
4610 Analysis of Facts

For each fact section, weigh the relevance of the facts and provide a clear, supportable analysis. Ensure that the analyses provide support for your determination.

Tax Return Filings

Analyze the taxpayer's filing history and taxable events occurring during your audit years.

Personal Residences

Evaluate the purchase, retention, and sale of all personal residences occupied by the taxpayer during the audit period.

If the taxpayer does not own a personal residence, analyze the following:

- If the taxpayer rented or leased a property, the length of the contract.
- The type of property (i.e., mobile home, apartment, studio, and motel).
- Whether or not the property was furnished.
- Whether or not the taxpayer's employer provided or paid for the taxpayer's housing.
- Whether the taxpayer stayed with family or with a friend.

Personal Transportation

Consider the type of vehicles, where the taxpayer maintained the vehicles, and the value of the vehicles. Also, determine whether the taxpayer shipped or transported the vehicles to another location. Analyze the location where vehicle expenses were incurred.

Pets

Consider the physical location of the pets during the audit period. Also, analyze the location where veterinary expenses and other pet expenses were incurred.

Businesses

Analyze the taxpayer's business interests in California, the claimed stated of residency and elsewhere (if relevant). In addition to the nature of the business, analyze the extent of the taxpayer's involvement with the business activities.

Employment

Determine where the taxpayer performed services during the audit period. Analyze the services performed in California and the claimed state of residence.
Voter Registration
Determine whether and when the taxpayer changed his or her voter registration to the claimed state or to California. Also analyze the taxpayer's voting history.

Driver's License
Analyze whether and when the taxpayer changed his or her driver's license to the claimed state or to California.

Bank Accounts
Analyze the banking information to determine the banking connections in California, the claimed state, and other locations. Connections to consider include:

- The location of the bank accounts.
- The dates the bank accounts opened and closed.
- The financial activity of the bank accounts.
- The payee location of canceled checks.
- The transaction location of ATM, point-of-sale, and debit transactions.

Credit Card
Analyze the credit card information to determine the credit card usage in California, the claimed state, and other locations.

Family
Consider the physical location of family members during the audit period.

Determine where the taxpayer's minor children lived, whether they accompanied the taxpayer, and the location where the children attended school. If the school-aged children did not accompany the taxpayer, analyze the reasons for this situation.

Memberships
Analyze the taxpayer's membership and involvement in clubs located in California, the claimed state, and elsewhere (if relevant).

Organizations
Analyze the taxpayer's membership and involvement in organizations located in California, the claimed state, and elsewhere (if relevant).

Professionals
Analyze the location and usage of medical, legal, and accounting professionals in California, the claimed state, and elsewhere (if relevant).

Physical Presence
Analyze the prepared physical presence calendars to determine the physical location of the taxpayer during the years under audit.

4620 Determining Domicile
Under California case law, domicile is defined as the one location with which, for legal purposes, a person is considered to have the most settled and permanent connections. Analyze the facts gathered during the audit to determine the location where the taxpayer maintained his or her most settled and permanent connections during the years under audit.

California case law also provides that a change of domicile requires:

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

Keep in mind that intent alone is not enough to change one’s domicile. All three actions are necessary in order for a taxpayer to change his or her domicile.

4630 Determining Residency

Once a determination is made concerning domicile, it is necessary to make a determination regarding residency. An individual domiciled in this state remains a resident of California if his or her absences from California are temporary or transitory in nature. Closest connections determine whether absences are temporary or transitory in nature.

You must determine a taxpayer’s residence by looking at all of the facts and circumstances of each particular case.

Carefully analyze the taxpayer’s connections within and without California. You must examine the connections to determine their importance to the individual taxpayer. Evaluate the connections in a fair and unbiased manner and support your evaluation by the facts of the case.

4640 Position Letter

A position letter explains the basis for the proposed adjustments. Prior to sending the position letter, discuss the results of the audit with the taxpayer and/or representative. See the MAP for more information.

Include the audit determination and the additional tax due in the first page of the position letter.

Information contained in the Audit Issue Sections will form the basis for the position letter. Make modifications to omit cross-referencing and any information deemed unnecessary to include in the position letter.

The position letter provides the taxpayer with an opportunity to indicate agreement or disagreement with the facts and the proposed adjustments.

4650 Taxpayer’s Position

If the taxpayer disagrees with your position, then the taxpayer needs to provide, in writing, the reasons for the disagreement along with supporting evidence, including applicable tax or case law, if appropriate. In
the applicable Audit Issue Sections, document the relevant facts and cited tax authority, which form the basis for the taxpayer’s disagreement.

4660 Rebuttal to Taxpayer’s Position

Review the basis for the taxpayer’s disagreement and all supporting evidence furnished with the taxpayer’s response. Carefully analyze any authority, such as BOE decisions, cited in the response. Address all areas of disagreement set forth in the taxpayer’s response to the audit determination. Include the rebuttal in the applicable Audit Issue Sections.

4670 Rebuttal Letter

If the issues raised by the taxpayer do not alter the determination set forth in your position letter, then prepare a rebuttal letter. The information contained in your rebuttal section of the Audit Issue Sections will form the basis for the rebuttal letter.

The rebuttal letter is the final letter communicated to the taxpayer or representative before issuing the Notice of Proposed Assessment (NPA) unless the taxpayer or representative presents relevant new information. If you anticipate a protest, inform the taxpayer of his protest rights and explain the proceedings that will follow.

4680 Alternative Position

If your taxpayer does not agree with your residency audit determination, consider whether a secondary issue, such as sourcing of compensation or business income, also exists. This ensures the proper assessment of tax in case your residency determination is overturned in the protest and appeal process.

If a secondary issue exists, include the issue as an Alternative Position in the applicable Audit Issue Section and your Narrative Report. Also, include the issue in your Notice of Proposed Assessment to the taxpayer.

Example:

Your taxpayer reported that his residency changed from California to Wyoming on January 1, 2000. He reported a $10 million gain from the sale of stock. The taxpayer also reported total compensation of $2 million and California source compensation of $500,000. Your taxpayer does not agree with your residency determination that he remained a California resident for taxable year 2000.

During the course of the audit, you determined that the compensation of $1.5 million, which was not reported as California source income, resulted from the taxpayer’s exercise of nonqualified stock options. You also determined that your taxpayer performed 100 percent of his services in California from the date of option grant to the date of option exercise.

In this situation, prepare an alternative position stating that the compensation of $1.5 million is California source income and taxable by California. Cite the applicable tax authority. Also, include this position and tax authority when you issue the NPA.

4700 Closing the Audit
The following sections address the final steps of the audit process:

**RSTM 4710** Narrative Report

**RSTM 4720** Case Review

**RSTM 4730** Case Assembly

**4710 Narrative Report**

Include the following information in your Narrative Report:

- Name and address of tax representative.
- Summary of the audit.
- Statute of limitations.
- Listing of audit issues.
- State tax adjustments.
- Recommendations.
- Taxpayer's position – brief summary.
- Rebuttal to taxpayer's position (if applicable) - brief summary.
- Alternative position (if applicable) - brief summary.

**4720 Case Review**

Occasionally, a reviewer will feel insufficient facts in the audit file support the conclusion, or that some facet of the case needs further development. Accordingly, when you complete the audit, inform the taxpayer or representative that a subsequent review might disclose the need for further development or changes to issues already agreed upon by the taxpayer.

**4730 Case Assembly**

Assemble the completed case as follows:

- Rush Tag (FTB 7011) if needed
- Audit Report (FTB 6430)
- PAWS Input Worksheet (FTB 6831) Leave loose
- Index to Audit File (FTB 9923)
- All received correspondence and documentation not in PASS
- Most recent tax return (original or amended) leave loose for audit support / TRS review to attach to front of file once case is done being processed*

*Returns for other audited years should be included in file for TRS review cases.

If the case file will be placed in archive boxes, please place a box label on the front of each box to identify the taxpayer name, taxpayer ID, and DLN(s)
Review the MAP for additional guidelines.