Residency and Sourcing Technical Manual

(Rev. 11/2022)

The information provided does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

Contents

1000 OVERVIEW

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

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.

The statutory definition of "resident" contains two alternative tests, the satisfaction of either one leads to a conclusion that the individual is a resident of this state.[1]

If a taxpayer is inside California for other than a temporary or transitory purpose, regardless of place of domicile[2], he or she is a resident of California. This is sometimes referred to as the inside or inbound test.[3]

Further, if a taxpayer is a domiciliary of California, he will be a California resident if his absences from California are for temporary or transitory purposes. This is sometimes referred to as the outside or outbound test.[4]

The policy behind California's personal income taxation of residents is to ensure that individuals, who are physically present in the state enjoying the benefits and protections of its laws and

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[1] *Appeal of L. Mazer and M. Mazer,* 2020-OTA-263P (July 23, 2020)

[2] *In most, if not all, residency disputes a taxpayers physical presence is generally blended between two or more locations; as such, this prong generally refers to taxpayers domiciled outside of California who have a physical presence inside of California.*

[3] *Appeal of L. Mazer and M. Mazer,* supra

[4] *Appeal of L. Mazer and M. Mazer,supra*

government, contribute to its support, regardless of the source of their income.[5]

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.

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.

Whether a person's presence in or absence from California is for a temporary and transitory purpose is a question of fact, determined by facts and circumstances.[6] That one may intend to move from California at some time in the future does not make that person who is in California there for a temporary or transitory purpose.[7] Therefore, one is a resident for tax purposes until there are sufficient indicia of an actual change of such residence.[8]

The determination cannot be based solely on the individual's subjective intent, but instead based on physical presence supported by objective facts.[9] The connections that a taxpayer maintains with this state when compared with other states are important indications of whether a person's absence from California is temporary or transitory.[10]

A person can have more than one residence for tax purposes, therefore, when a California domiciliary leaves the state it is particularly relevant to determine whether the taxpayer substantially severed his California connections upon his departure or whether he maintained his California

[5] *Appeal of Ralph G. and Martha E. McQuoid, 89-SBE-014 (May 11, 1989).*
[6] *Appeal of Terrance and Brenda Harrison, 85-SBE-059 (June 25, 1985); Appeal of L. Mazer and M. Mazer, 2020-OTA-263P (July 23, 2020).*
[7] Appeal of Anthony V. and Beverly Zupanovich, 76-SBE-002 (Jan. 6, 1976); Noble v. Franchise Tax Board (2004) 118 Cal.App.4th 560.
[8] *Appeal of Anthony B. and Beverly Zupanovich, supra; Noble v. Franchise Tax Board, supra*.
[9] *Appeal of Anthony B. and Beverly Zupanovich, supra; Noble v. Franchise Tax Board, supra*
[10] *Appeal of Stephen Bragg*, 2003-SBE-002 (May 28, 2003)*; Appeal of L. Mazer and M. Mazer, supra.*

connections in readiness for his return.[11]

Mere formalisms such as changing voting registration to another state or statements to the effect that the TP intended to be a resident of another state are not controlling.[12]

Athletes: California recognizes that its athletes will generally be outside of California to fulfill contractual obligations. In general, in cases involving athletes the primary focus is on the connections the taxpayer maintains with California and the other state during the offseason.[13]

In **Bragg**, the Board of Equalization (BOE) identified multiple factors that are helpful in determining where an individual's closest connections lie, and thus the purpose of a taxpayer's presence in a particular location (California versus).[14]The factors, stated in Bragg, are merely meant to serve as a guide in determining residency.[15]

- 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

[11] *Whittel v. Franchise Tax Board (1964) 231 Cal. App. 2d 278, 284*; *Appeal of L. Mazer and M. Mazer, supra; Appeal of Terrance and Brenda Harrison*, *supra*

[12] *Appeal of Tyrus R. Cobb, 1959-SBE- 014, March 26, 1959*

[13] Appeals *of Joe and Gloria Morgan*, supra and *Jimmy J. Childs,* 83-SBE-128 (June 21, 1983).

[14] *Appeal of Stephen Bragg*, supra; *Appeal of L. Mazer and M. Mazer, supra*.

[15] *Appeal of Stephen Bragg, supra; Appeal of L. Mazer and M. Mazer, supra*

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.

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.

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.

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, 1951-SBE-005, July 19, 1951,** the Board of Equalization 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 the place with which a person has the most settled and permanent connections and the place to which an individual intends to return to whenever absent.[16] An individual may have several residences simultaneously, but an individual can only have one domicile at any given time.[17]

One does not lose a former domicile by going to and stopping at another place for a limited time with no intention to reside there permanently. One's acts must give clear proof of a concurrent intention

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[16] *Whittel v. Franchise Tax Board* (1964) 231 Cal. App. 2d 278, 284; *Appeal of L. Mazer and M. Mazer, 2020-OTA-263P (July 23, 2020).*

[17] Cal. Code Regs., tit. 18, § 17014(c); *Whittell v. Franchise Tax Bd., supra*; *Appeal of L. Mazer and M. Mazer, supra*

to abandon the old domicile and establish a new one.[18]

In order to change one's domicile, a person must (1) actually move to a new residence and (2) intend to remain there permanently or indefinitely.[19] Intent is not determined merely from unsubstantiated statements; the individual's acts and declarations will also be considered.[20]

Retention of significant California connections are influential in the determination of a taxpayer's domicile.[21] When it cannot be clearly decided which of several dwelling places is the taxpayer's domicile, the place of domicile continues to be the first established one.[22]

Married Taxpayers: The location of a familial or marital abode is given significant weight in determining an individual's domicile.[23] In the **Appeal of Mazer**, the panel held taxpayer was a domiciliary of California because appellant-husband's marital abode continued to remain in California; the address of appellant-husband's marital abode was used on appellants' California tax returns; and after appellant-husband's employment concluded he returned to his marital abode in California.[24]

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

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[18] *Chapman v. Superior Court, (1958) 162 Cal. App. 2d 421*

[19] *Noble v. Franchise Tax Board* (2004) 118 Cal.App.4th 560; *Appeal of L. Mazer and M. Mazer, supra*

[20] *Appeal of Joe and Gloria Morgan*, 85-SBE-078 (July 30, 1985); *Noble v. Franchise Tax Board, supra* at p. 568; *Appeal of L. Mazer and M. Mazer, supra*.

[21] *Appeal of Anthony V. and Beverly Zupanovich*, 76-SBE-002 (Jan. 6, 1976); *Whittel v. Franchise Tax Board, supra.*

[22] *Appeal of Anthony J. and Ann A. D'Eustachio*, 85-SBE-040 (May 8, 1985)

[23] *Appeal of Annette Bailey*, 76-SBE-016 (March 8, 1976); *Appeal of Charles P. Varn,* 77-SBE-104 (July 26, 1977); *Appeal of L. Mazer and M. Mazer, supra*

[24] *Appeal of L. Mazer and M. Mazer, supra*.

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, 231 Cal.App.2d 278 (1964)**.

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, 1908-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, 1968-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. See **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, 1972-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 Terance and Brenda Harrison, 1985-SBE-059, June 25, 1985**.)

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, 1976-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, 1985-SBE-075, July 30, 1985 and the Appeal of William G. and Susan G. Crozier, 1992-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, 1986-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

3100 California Taxation

Residents

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

Example 1

Mary, a California resident, has the following income:

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

Determination:

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

Nonresidents

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

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

Example 2

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

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

Total	$85,000

Determination

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

Part-Year Residents

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

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

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, 2019. She earned the following income during 2019:

FL wages from January 1, 2019 to June 30, 2019	$50,000
CA wages from January 1, 2019 to June 30, 2019	$10,000
CA wages from July 1, 2019 to December 31, 2019	$30,000
FL wages from July 1, 2019 to December 31, 2019	$5,000
Total	$95,000

Determination:

California taxes the following income:

CA wages from January 1, 2019 to June 30, 2019	$10,000
CA wages from July 1, 2019 to December 31, 2019	$30,000
FL wages from July 1, 2019 to December 31, 2019	$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.

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:

Prorated tax = California taxable income x (Tax on total taxable income/Total taxable income)

Key Definitions

Table 1. Key Definitions

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

Percentage Calculations

Table 2. Percentage Calculations

Item	Formula
Itemized or standard deductions:	Divide the California AGI by the total AGI (not to

Item	Formula
	exceed 1.0): <u>California AGI</u> Total AGI
Tax rate:	Divide the tax on total taxable income by the total taxable income: <u>Tax on total taxable income</u> Total taxable income
Credits:	Divide the California taxable income by the total taxable income: <u>California taxable income</u> Total taxable income Note: This percentage does not apply to renter's credit, other state tax credit, or credits conditional upon a transaction occurring wholly within California. California allows these credits in full.

The following example shows how the calculation works:

Example 4

Taxable Year 2019

John was a Florida resident until March 31, 2019. While a Florida resident, he earned and received wage income of $15,000 and interest income of $1,000. On April 1, 2019, 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 2019:

Table 3. Example 4

Deduction	Amount	Description
Real estate taxes	$1,200	CA house
Real estate taxes	$800	FL house
Mortgage interest	$17,000	CA house
Mortgage interest	$3,500	FL house
Charitable contributions	$1,500	NY firefighters fund
Total	**$24,000**	

Table 4. Calculation of John's Tax Liability

Deduction	Amount	Description
California AGI	$65,000	California wages
	+$3,000	Interest earned while a CA resident
	$68,000	
Total AGI	$80,000	Wages from all sources
	+$4,000	Interest income from all sources
	+84,000	
CA itemized deductions	$24,000	Total itemized deductions
	X .8095	CA AGI/Total AGI

Deduction	Amount	Description
	$19,428	
CA taxable income	$68,000	CA AGI
	-$19,428	CA itemized deductions
	$48,572	
Total taxable income	$84,000	Total AGI
	-$24,000	Total itemized deductions
	$60,000	
Tax on total taxable income	$3,705	Tax table
Prorated tax	$48,572	California taxable income
	X .0618	<u>Tax on total taxable income</u> Total taxable income
	$3,002	
Prorated exemption credit	$80	Personal exemption credit
	X .8095	<u>California taxable income</u> Total taxable income
	$65	
Tax Liability	$3,002	Prorated tax

Deduction	Amount	Description
	$65	Prorated exemption credit
	$2,937	

3150 Community Income

RSTM 3160	Community Property Jurisdictions
RSTM 3170	Community Property Definition
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RSTM 3190	Separation of Spouses
RSTM 3195	How to Split Income Between Spouses; then Source

3160 Community Property Jurisdictions

There are nine states that have adopted community property laws: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Other countries have also adopted community property laws. The most common are China, Taiwan, and Japan.

Notable countries that do not recognize community property laws are Hong Kong, South Korea, United Kingdom, and Singapore.

3170 Community Property Definition

California Family Code (CFC) Section 760 provides that all property, real or personal, regardless of location, acquired by married persons during marriage while domiciled in California is community property.

All property, acquired by either spouse during the marriage is community property & the burden is on the party seeking to establish that such property is in fact separate. **Thomasset v. Thomasset** (1953) 122 Cal. App. 2d 116, 124

California community property laws provide that an individual's marital property interest in personal property is determined by the laws of the acquiring spouse's domicile. **Schecter v. Superior Ct.** (1957) 49 Cal.2d 3, 10; **Rozan v. Rozan** (1957) 49 Cal.2d 322, 326

If one spouse is a resident of California & the other spouse is a resident of a community property state, the California spouse is liable for California income tax on his/her 1/2 community property interest in the other spouse's earnings. **Appeal of Roy L. and Patricia A. Misskelley,** 84-SBE-077, May 8, 1984

3180 Separate Property

Separate property of a married person includes all of the following (**CFC Section 770**):

1. All property owned by the person before marriage.
2. All property acquired by the person after marriage by gift, bequest, devise, or descent.
3. The rents, issues, and profits of the property described in this section.

A married person may, without the consent of the person's spouse, convey the person's separate property.

The burden is on the party claiming property is separate property to establish its character as such, & that when he fails to do so the presumption that it is community property is controlling. **Patterson v. Patterson (1966) 242 Cal. App. 2d 333, 341**

The property rights of spouses prescribed by statute may be altered by a premarital agreement or other marital property agreement. (**CFC Section 1500**)

3190 Separation of Spouses

Property acquired by a married person while "living separate and apart" from the other spouse is considered separate property (**CFC Section 771(a)**)

"Living separate and apart" refers to "that condition when spouses have come to a parting of the ways with no present intention of resuming marital relations."**Marriage of Baragry (1977) 73 Cal.App.3d 444**

3195 How To Split Income Between Spouses, Then Source

Here is an example of how to split the income between spouses, then source accordingly based on their state of residence:

Example 1

Husband is a nonresident and had wages of $100K; all services performed in NV.

Wife is a CA resident and had wages of $50K; all services performed in CA.

Determination:

	SPLIT		SOURCE	
	Husband	Wife	Husband	Wife
NR Husband wages $100K	50	50	0	50
R Wife wages $50K	25	25	25	25
Total			25	75

If they filed:

MFJ, they would file a **540NR** & source wages of $100K (25 +75) on **Sch CA** (540NR), Col E.	**MFS**, the wife would file a **540** resident return reporting $75K & the husband would file a **540NR** & source $25k on **Sch CA** (540NR), Col E

3200 Compensation for Personal Services

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

RSTM 3205	Taxpayer Becomes a California Resident (Move-In)
RSTM 3210	Taxpayer Becomes a Nonresident (Move-Out)/Taxpayer is a Nonresident for the Entire Year
RSTM 3215	Allocation of Compensation
RSTM 3220	Sick Leave, Vacation Pay, Bonuses, and Severance Pay
RSTM 3225	Deferred Compensation Plans
RSTM 3230	Tax Equalization Payments
RSTM 3235	Moving Expenses

3205 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, 2019. He permanently moved to California on May 3, 2019. On May 7, 2019, Bill received his last monthly paycheck of $3,000 via direct deposit 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 3970.

3210 Taxpayer Becomes a Nonresident (Move-Out)/Taxpayer is a Nonresident for the Entire Year

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

Income from sources within this State includes income from compensation for personal services performed within this State. (**CCR §17951-2**)

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

Example 1

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

Determination:

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

Example 2

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

Determination:

The $25,000 Steven earns while working in New York is not California source income. He did not perform the underlying services in California. However, because California residents are taxed on income from all sources, the $25,000 Steven earns in New York is taxable by California. If Steven also pays tax to New York, he is allowed an Other State Tax Credit on this double-taxed income. See RSTM 3970.

Example 3

Jamie lived and worked exclusively in California until she retired on December 31, 2019. She moved to Nevada on January 1, 2020. Her former California employer pays its employees on the 5th of every month. On January 10, 2020, 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.

3215 Allocation of Compensation

When a part-year resident or a nonresident employee 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 17951-5 provides the following rules for allocating wages, salaries, and other compensation received by employees for services performed within California:

Table 5. Allocation Methods

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

Category	Allocation Method
Employed in CA at intervals throughout the year and paid on some other basis.CCR Section 17951-5(b)	Reasonable manner

What constitutes a reasonable allocation method so as to properly limit a taxpayer's gross income to that earned from California sources must be based upon the facts and circumstances of each case,. (See, e.g., **Appeal of Pesiri (89-SBE-027) 1989 WL 129195**.)

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

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

Airline Employees

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

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

Total wages x (Scheduled flight time in California/Total scheduled flight time) = California source wages

Railroad Employees and Truck Drivers

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

Military Personnel

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

California does not tax the military compensation of a service member not domiciled in California.

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

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

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

3220 Sick Leave, Vacation Pay, Bonuses, and Severance Pay

Nonresidents

Benefits that are directly related to California employment such as sick leave, bonuses, vacation pay, and severance pay, are includible as California income. (See **Appeal of Edwin O. and Wanda L. Stevens, 86-SBE-100, May 6, 1986; Appeal of William H. Harmount and Estate of Dorothy E. Harmount, Deceased, 77-SBE-121, Sept. 28, 1977**.)

Salaries, fees, bonuses, commissions, including those on sales or insurance premiums, pensions, and retired pay are wages within the meaning of the statute if paid as compensation for services performed by the employee for his or her employer. (**CCR §4309-1(a)(2)**)

Any payments made by an employer to an employee on account of dismissal, that is, involuntary separation from the service of the employer, constitute wages regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments. Dismissal payments, as used in this subparagraph, include but are not limited to, severance pay, in-lieu-of-notice pay, supplemental unemployment, and termination pay. (**CCR §4309-1(b)(4)**)

Residents

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

Example 1

Richard lived and worked in New York until June 30, 2019, the date of his employer's taxable year-end. He permanently moved to California on July 5, 2019. On July 20, 2019, Richard received a bonus check of $10,000 from his former New York 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 New York on this bonus, he is allowed an Other State Tax Credit. See RSTM 3970.

3225 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.

3230 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, 2019. On August 1, 2019, Esther permanently moved to California and on August 15, 2019, 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.

3235 Moving Expenses

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

3250 Equity-Based Compensation

RSTM 3255	Introduction
RSTM 3260	Internal Revenue Code Section 83
RSTM 3265	Nonstatutory Stock Options (NQSO)
RSTM 3270	Incentive Stock Options (ISO)
RSTM 3275	Restricted Stock and Restricted Stock Units (RSU)
RSTM 3280	Employee Stock Purchase Plans
RSTM 3285	California Qualified Stock Options
RSTM 3290	Summary Table

3255 Introduction

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

Term	**Definition**
Grant date	The date the company grants the option to the employee.
Option price	The price the employee will pay for the stock (also referred to as the grant price or exercise price).
Exercise date	The date the employee purchases the stock at the option price.
Vesting date	The date the options become exercisable. For restricted stock, this is the date the options become taxable.
Qualifying disposition	A disposition that meets the following IRC Section 422 or IRC Section 423 holding period requirements: No sale of the stock within 2 years from the grant date of the option. No sale of the stock within 1 year after the date the taxpayer exercises the option.

Term	Definition
Disqualifying disposition	A disposition that does not meet the holding period requirements of IRC Section 422 or IRC Section 423.

3260 Internal Revenue Code Section 83

IRC Section 83 governs nonstatutory stock options and restricted stock.

IRC section 83(a), which is incorporated into California law by **R&TC section 17081**, governs the taxation of property transferred in connection with the performance of services. Under IRC section 83(a), gross income for tax purposes includes income from such property, in the first tax year in which "the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier." (IRC, § 83(a)(1).) A substantial risk of forfeiture exists where the rights of a person in property are conditioned, directly or indirectly, upon the future performance of substantial services by any individual. (IRC, § 83(c)(1).) The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture. (IRC, §83(c)(2).)

3265 Nonstatutory Stock Options (NQSO)

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.

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 Aileene R. Barnett, 1980-SBE-122, October 28, 1980***.

Example 1

On March 1, 2015, while a resident of Michigan, Fred was granted nonstatutory stock options. On June 1, 2019, he retired and permanently moved to California. On August 1, 2019, 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, 2019, and the option price is wage income taxable by California. If Fred also paid tax to Michigan, he is allowed an OSTC against California taxes paid to Michigan on this double-taxed income.

Nonresident of California on Exercise Date

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

All services 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, 2014, while a resident of California, Joan was granted nonstatutory stock options. Joan performed all of her services in California from February 1, 2014, to May 1, 2019, the date she left the company and permanently moved to Texas. On June 1, 2019, Joan exercised her nonstatutory stock options.

Determination:

The difference between the fair market value of the shares on June 1, 2019, 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 an employee performed services both within and without California, they must allocate to California that portion of total compensation reasonably attributed to services performed in this state (**CCR Section 17951-5**).

One reasonable method is an allocation based on the time worked. The period of time the employee performed services includes the total amount of time from the grant date to the exercise date (or the date the employee's employment ended, if earlier). This method of allocation was sustained by the Office of Tax Appeals (OTA) in the ***Appeal of Stabile, 2020-OTA-198P***.

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, 2015, while a resident of Texas, Betty was granted nonstatutory stock options. On July 1, 2016, she was permanently transferred to California. On July 1, 2019, she left the company and permanently moved to Florida. From July 1, 2015 through July 1, 2019, she worked for the company a total of 700 days in California and 300 days in other states. On August 1, 2019, she exercised her options.

Determination:

The difference between the fair market value of Betty's shares on August 1, 2019, and the option price is stock option income characterized as compensation for services. Since Betty left the company prior to exercise, we will use total workdays from grant date to the date her employment ended: 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.

3270 Incentive Stock Options

Qualifying Disposition

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

Disqualifying Disposition

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

Incentive Stock Option Tax Treatment Summary Table

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

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

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, 2015, 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 2019.

Determination:

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

Table 6. ISO Limitation

Vest Date	Shares Vested	Vest Value	Value Over Limit	Shares Over Limit	ISO Shares Granted	NQ Shares Granted
01/01/2015	7,500	$150,000	$50,000	2,500	5,000	2,500
01/10/2016	7,500	$150,000	$50,000	2,500	5,000	2,500
01/01/2017	7,500	$150,000	$50,000	2,500	5,000	2,500

Vest Date	Shares Vested	Vest Value	Value Over Limit	Shares Over Limit	ISO Shares Granted	NQ Shares Granted
01/01/2018	7,500	$150,000	$50,000	2,500	5,000	2,500
Totals	**30,000**				**20,000**	**10,000**

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 2019, 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, 2015, while a resident of Ohio, Peter was granted incentive stock options. On April 1, 2018, he exercised his options. On September 1, 2019, Peter permanently moved to California and sold his stock on October 15, 2019, 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, 2015, while a resident of Ohio, Sally was granted incentive stock options. On April 1, 2019, she exercised her options. On June 1, 2019, Sally permanently moved to California and sold her stock on October 1, 2019. 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, 2016, Mark was granted an incentive stock option. On March 1, 2018, 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, 2019, he permanently moved to Illinois. On June 1, 2019, he sold the stock at a gain.

Determination:

Mark must make an AMT adjustment on his 2018 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 2019 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, 2017, Harry was granted an option to purchase stock under his company's incentive stock option plan. The option price on April 1, 2017, was $10 per share. On April 1, 2019, 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, 2019, was $50 per share. On July 1, 2019, Harry retired and permanently moved to Florida. On October 15, 2019, 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 7. Example 5

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

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

Harry does not need to make an AMT adjustment in tax year 2019 because he disposed of the stock in the same year he exercised his option.

Example 6

Assume the same facts as the previous example, except Harry sold the stock on March 15, 2020, when the fair market value of the stock was $60 per share.

Determination:

<u>Tax Year 2019</u>

Harry must make an alternative minimum tax adjustment in tax year 2019 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 8. Example 6

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

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

Table 9. AMT Basis

Description	Amount
Option price:	$300,000
Plus AMT adjustment:	1,200,000
AMT basis:	$1,500,000

Tax Year 2020

Wage income from a California source is determined as follows:

Table 10. 2020 CA Source Wages

Description	Amount	Details
FMV of stock, date of exercise:	$1,500,000	(30,000 shares @ $50 per share)
Less option price:	-300,000	(30,000 shares @ $10 per share)

Description	Amount	Details
FMV of stock, date of exercise:	$1,500,000	(30,000 shares @ $50 per share)
Wage income, CA source income:	$1,200,000	

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

Table 11. Capital Gain

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

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

3275 Restricted Stock and Restricted Stock Units (RSU)

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, 2014, 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, 2018, Brad's employer permanently transferred him to California. On March 1, 2019, 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, 2019, and the price Brad paid for the stock on March 1, 2014, 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 services 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, 2016, 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, 2016, to December 31, 2018, the date she left the company and permanently moved to Wyoming. On February 1, 2019, Judy's stock vested.

Determination:

The difference between the fair market value of the stock on February 1, 2019, and the price Judy paid for the restricted stock on February 1, 2016, 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 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). This method of allocation was sustained by the Office of Tax Appeals (OTA) in the **Appeal of Stabile, 2020-OTA-198P**.

The allocation ratio is:

California workdays from purchase date to vesting date
Total workdays from purchase date to vesting date

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

Example 3

On November 1, 2015, 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, 2019, she left the company and permanently moved to Texas. From November 1, 2015, through October 1, 2019, Bonnie worked for the company a total of 700 days in California and 300 days in other states. On November 1, 2019, the stock vested.

Determination:

The difference between the fair market value of Bonnie's stock on November 1, 2019, and the price she paid for the restricted stock on November 1, 2015, is characterized as compensation for services. Since Bonnie left the company prior to the vesting date, we will use total workdays from grant date to the date her employment ended: 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 Bonnie's restricted stock income.

3280 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.

Qualifying Disposition

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

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

Disqualifying Disposition

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

California Resident on Date of Stock Sale

Qualifying or Disqualifying Disposition

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

Example 1

On March 1, 2016, while a resident of Massachusetts, Sam's employer granted him options at a discount under the company's stock purchase plan. On March 1, 2018, Sam exercised his options. On December 1, 2018, Sam permanently moved to California and on April 1, 2019, 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, 2016, Michelle's employer granted options to her under the company's employee stock purchase plan. On February 1, 2018, 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, 2018, she permanently moved to Nevada and on January 15, 2019, 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.

3285 California Qualified Stock Options

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

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

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

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

See RSTM 3270, 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 3265, Nonstatutory Stock Options, to determine the California taxation of these options if there is a change in the taxpayer's residency.

3290 Summary Table

Type	California residents	California nonresidents
Nonstatutory stock option (NSO)	on the date of NSO exercise: California taxes the wage income. Possible other state tax credit.	on the date of NSO exercise NSO: California taxes the wage income to the extent services were performed in California from the grant date to the

Type	California residents	California nonresidents
		exercise date. Possible other state tax credit.
	on the date of stock sale: California taxes the capital gain.	on the date of stock sale: 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 of ISO exercise: If the stock is not sold in the year of exercise, make AMT adjustment. Include AMT adjustment to the extent services were performed in California from the grant date to the exercise date. 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 qualifying disposition at a gain: California does not tax 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 date the stock is sold in a disqualifying disposition: California taxes the wage income to the extent services were performed in California from the grant date to the exercise date. California does not tax the capital gain (if any). Possible other state tax credit.

Type	California residents	California nonresidents
		Possible AMT Credit.
Restricted Stock (RSU)	on the vesting date: California taxes the wage income. Possible other state tax credit.	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)	on the date the stock is sold in a qualifying or disqualifying disposition at a gain: California taxes the ordinary income and capital gain. Possible other state tax credit.	on the date the stock is sold in a qualifying or disqualifying disposition at a gain: California taxes the ordinary income to the extent services were performed in California from the grant date to the exercise date. California does not tax the capital gain (if any). Possible other state tax credit.
California qualified stock options (CQSO)	and R&TC Section 17502 provisions are met: Same tax treatment as ISO.	and R&TC Section 17502 provisions are met: Same tax treatment as ISO.
	and R&TC Section 17502 provisions are not met: Same tax treatment as NSO.	and R&TC Section 17502 provisions are not met: Same tax treatment as NSO.

3300 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 2019 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 2

Laura is a nonresident of California. During 2019, she received qualified pension income, which she earned by performing services in California from 1990 through 2017.

Determination:

Because Laura is a nonresident of California; the qualified pension income received in 2019 does not have a California source and is not taxable by California.

Example 3

Michael worked for his California employer for 20 years and retired in January 2019. He moved to Nevada in March 2019 and received a lump-sum payment in June 2019 from his former California employer's executive retirement plan.

Determination:

Since this was a lump-sum payment this does not qualify as qualified retirement income under R&TC Section 17952.5(b)(9)(A). This would be considered deferred compensation. See RSTM 3225 and FTB Legal Ruling 2011-02.

3350 Intangible Personal Property

R&TC Section 17952 states that income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this state unless the property has acquired a business situs in California.

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

Example 1

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

Determination:

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

Example 2

Stephanie moved from Nevada and became a California resident on May 1, 2019. However, she kept her money in a bank account in Nevada. From May 1, 2019, to December 31, 2019, 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, 2019, the interest earned by Stephanie from May 1, 2019, to December 31, 2019, is considered California source income.

Example 3

During 2019, 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.

<u>Business Situs</u>

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 Section 17952(c)**.

Source Determined at Disposition

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 Section 17952(d)**.

Example 4

Robert, a life-long California resident, reported a capital loss carryover from the sale of securities for tax year 2018. On January 1, 2019, Robert permanently moved to Florida. On June 1, 2019, Robert sold vacant land located in California and realized a capital gain from the sale.

Determination:

Although Robert was a resident of Florida in 2019, the capital gain from the sale of land located in California is sourced to California. Because Robert was still a California resident in 2018, when 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.

Qualifying Investment Securities

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

Sale of Partnership or S- Corp Interest

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

Under Subchapter K, which California generally conforms to, when a partner disposes of his interest in a PS/LLC, the gain is generally capital gain. The general rule is the gain from the sale of a partnership/LLC interest at the individual level is considered intangible and sourced to state of residence (**R&TC Section 17952**). However, if the partnership holds unrealized receivables or inventory (commonly referred to as "hot assets"), **IRC Section 751** provides for the bifurcation of the sale of the interest into two transactions – the sale of the partnership interest and the deemed sale of the underlying Section 751 assets by the partnership immediately before the interest disposition. Since the purpose of IRC Section 751 is for the reporting of ordinary income of a partnership, the nature of the income attributable to the 751 assets is business income. If the partnership does business entirely within California, **R&TC Section 17951-4(a)** provides that all gain or loss associated with the 751 property is sourced to California. The remainder is treated as gain from the sale of the partnership interest (an intangible) sourced under Section 17952. However, if the partnership is doing business within and without California, the 751 income is sourced under **Section 17951-4(d).** See **FTB Legal Ruling 2022-02**.

However, if the interest is sold at the entity level resulting in a flow-through gain/loss, the nonresident individual may have California source gain/loss. See RSTM 3500 for more information.

Sale of S Corporation Stock

Gain or loss recognized by a nonresident on the sale of S corporation stock is considered intangible and sourced to state of residence (**R&TC Section 17952**), However, if the S corporation generates a flow-through capital gain from its sale of intangible assets (e.g. goodwill), the shareholder's pro rata share of the income is sourced under **R&TC Section 17951-4(d).** See RSTM 3500 and for more information.

3400 Business, Trade, or Profession

CCR § 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 § 17951-4(b) provides that if the nonresident's sole proprietorship is conducted partly within and partly without California but the part within the state is separate and distinct and unconnected (not unitary) with the part without the state, then only the portion related to the trade or business within this state is California source.

Example 1

Julie, an Oregon resident, operates a real estate business which operates solely within California and a separate and distinct (nonunitary) retail business in Oregon.

Determination:

CCR § 17951-4(b) provides that Julie includes only the net income from the real estate business as California source income. As Julie's retail business is separate and distinct (nonunitary) and operates wholly within Oregon, none of that income is California source income.

CCR § 17951-4(c) provides that if a sole proprietorship operates in and out of California and the in-state activities and out-of-state activities are unitary, we determine the amount of net income derived from sources within California in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act (UDIPTA) as contained in **R&TC § 25120-25139** and their related regulations (**CCR § 17951-4**).

To simplify, if the business is carried on:

- Wholly within CA, entire net income is CA source income. CCR § 17951-4(a)
- Within & without but the part within is not unitary with the part without, only the part within is CA source income. CCR § 17951-4(b)
- Within & without CA and the in-state and out-of-state activities are unitary. CCR § 17951-4(c)
    - Business income is apportioned (**CCR § 17951-4 & R&TC § 25120-25139**) (UDITPA)
    - Nonbusiness income is sourced (**R&TC § 17951-17955**)
    - If the nonbusiness income is from an intangible, the income is sourced to the state of residence. Nonbusiness income from intangible can be CA source income if the intangible asset has developed a business situs in CA (see CCR § 17952).
    - If the nonbusiness income is from tangible or real property, the income is sourced to the location of the property (see CCR § 17951-3).

- **<u>How To Source Business Income Derived From Within And Without California</u>**
- <u>Single Sales Factor applies</u>
- In general, for taxable years beginning on or after January 1, 2013, "an apportioning trade or business," which includes a nonresident's business, trade, or profession that carries on within and out of California is required to apportion business income using the single sales factor.
- Prior to enactment of the single sales factor, California apportioned income based on a formula that sourced income based on the property, payroll, and sales of a business. The three-factor formula is an exception that is still used by certain "qualified business activities." See R&TC § 25128(b) for definition of the term qualified business activity.
- <u>Rules for assigning sales</u>
  - Tangible Personal Property

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

    1. The property is delivered or shipped to a purchaser in California and the taxpayer is taxable in California.
    2. The property is shipped from California to a state where the taxpayer is not taxable or the purchaser is the U.S. Government.
  - Other Than Tangible Personal Property (i.e. services and sales of intangibles)
  - Beginning in 2013, all taxpayers with income inside the state and outside the state must use the market-based sourcing rules provided by R&TC § 25136. Under market assignment, sales of other than tangible personal property are assigned to the California sales factor numerator if:

    1. Sales from services are in California to the extent the purchaser of the service received the benefit of the services in California.
    2. 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.
    3. Sales from the sale, lease, rental, or licensing of real property are in California if the real property is located in California.
    4. Sales from the rental, lease, or licensing of tangible personal property are in California if the property is located in California.

Prior to 2013, taxpayers used the "cost of performance" to assign sales. Thus, the sales were generally assigned to the state where the greater cost of performance based on income producing activities were performed e.g. where most of the direct work (based on cost) in producing that income was done. As described above, the cost of performance rules have been replaced by market-based sourcing rules.

Example 2

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 business income from her web design business is $500,000. The sales receipts from California customers that received the benefit of service from California are $600,000 out of the total sales receipts everywhere of $1,000,000. Does Jill have a filing requirement in California? If yes, how much of her web design business income is sourced to 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 market assignment, sales of services are assigned to California if the purchaser of the service received the benefit of the service in California. Accordingly, $600,000 will be assigned to the California sales factor numerator for Jill's sole proprietorship and Jill would apportion 60% ($600,000 CA sales/$1,000,000 total sales) of its business income of $500,000 from her sole proprietorship to California. Jill's California source income from her Sole Proprietorship is $300,000 ($500,000 x 60% sales factor).

Example 3

Jack, a resident of Nevada, performs tax and accounting services from his home for clients in both California and Nevada. Jack received $550,000 of fees from California clients who received the benefit of service in California. Even though Jack performs all services for the California client in Nevada, are the $550,000 in fees considered California sales?

Determination:

Yes, the $550,000 in fees are considered California sales under the market based rule. Jack has a filing requirement in California because the California sales from his tax and accounting business will result in California source income even if Jack performs all services for this client in Nevada. Jack should file a Schedule R to determine the amount of business income apportioned to California that is considered California source income. If however, the California customer hired Jack for tax and accounting services for the customer's business located in Nevada, then the California customer received the benefit of service in Nevada and $550,000 is not considered California sales under the market based rule even if the customer is from California.

As this example shows, it's not enough that the customer is in California. The customer has to receive the benefit of service in California. The customer can actually be anywhere as long as the benefit of service is received in California.

Questions?

For more details on how the sales factor rules are applied, please see the Multistate Audit Technique Manual (MATM) Section 7500.

If you need additional help determining the source of a nonresident sole proprietor's business and/or nonbusiness income within and without California, please talk to your lead and/or supervisor to request assistance from an apportioning subject matter expert (SME).

3450 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:

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

Example 1

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

Determination:

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

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

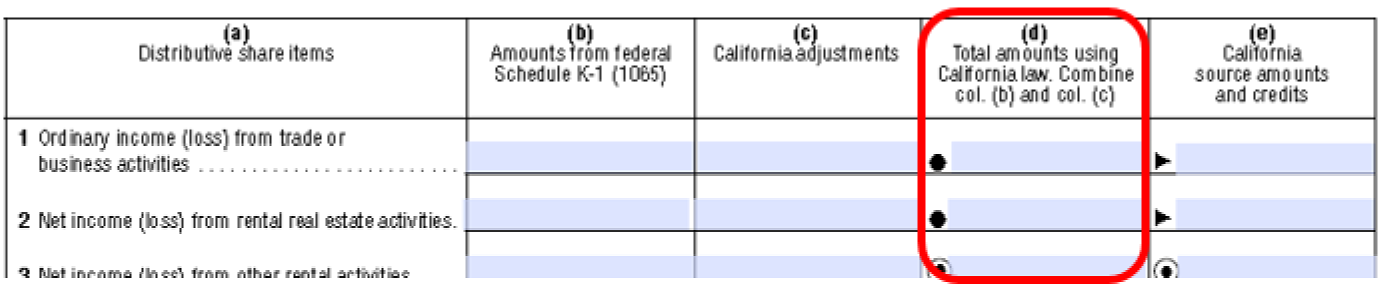
3500 Flow-through Income from Pass-Through Entities (PTEs)

Partnerships, LLCs, and S Corporations "flow through" their income to the owners (see RSTM 3550 for discussion of flow-through income from Trusts). Each owner's share of the entity's tax items is referred to as a "distributive share." California law determines whether or not an owner's distributive share is taxable in whole or in part in California. Different rules apply depending on whether the taxpayer is a resident or a nonresident.

Residents

California residents are taxable on their entire distributive share of flow-through income regardless of source. **CRTC § 17041(a) and (c)**.

Generally, when a California resident receives a Schedule K-1 from a PTE, they should use the information in column d (Total Amounts using California Law) to report their share of the flow-through items, not column e (California Source Amounts).



(a) Distributive share items	(b) Amounts from federal Schedule K-1 (1065)	(c) California adjustments	(d) Total amounts using California law. Combine col. (b) and col. (c)	(e) California source amounts and credits
1 Ordinary income (loss) from trade or business activities			●	▶
2 Net income (loss) from rental real estate activities.			●	▶
3 Net income (loss) from other rental activities			●	●

Nonresidents

California taxes a nonresident's distributive share of PTE income derived from California sources.

- Distributive share of income from PTEs operating **wholly within** California

  CCR § 17951-4(a) provides 100% of the income is derived from California sources.

- Distributive share of business income from PTEs operating **wholly without** California

  CCR § 17951-4(a) provides none of the income is derived from California sources.

- Distributive share of income from PTEs operating **within and without** California

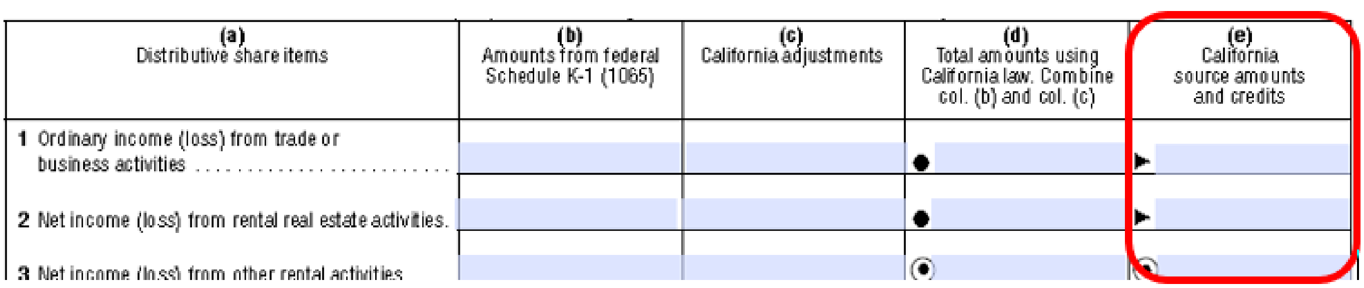
  CCR § 17951-4(d) provides if a nonresident is a partner in a partnership[25] which carries on a unitary business, trade or profession within and without this state, the partner's distributive share sourced to California is comprised of business income apportioned and nonbusiness income allocated to California. To classify their income as business or nonbusiness, the apportioning PTEs follow the provisions of the Uniform Division of Income for Tax Purposes Act (UDIPTA) as contained in CRTC § 25120-25139. See RSTM 3400.

Business Income

The nonresident partner's distributive share of partnership business income apportioned to California is California source income. See **CCR § 17951-4(d)**, the **Appeal of Lore Pick, 1985-SBE-066, June 25, 1985**, and the **Appeal of George D. Bittner, 1985-SBE-111, October 9, 1985.**

The PTE's business income apportioned to California retains its character as California source income when it flows through to the nonresident. Thus, the determination of how to source a nonresident's distributive share from an apportioning PTE's business income is done at the entity level under UDIPTA.

Generally, when a nonresident receives a Schedule K-1 from an apportioning PTE, they should use the information in column e (California Source Amounts) to report their share of the flow-through items that is considered CA source income. The amounts from column d will be used to compute the nonresident's total taxable income.



(a) Distributive share items	(b) Amounts from federal Schedule K-1 (1065)	(c) California adjustments	(d) Total amounts using California law. Combine col. (b) and col. (c)	(e) California source amounts and credits
1 Ordinary income (loss) from trade or business activities				
2 Net income (loss) from rental real estate activities				
3 Net income (loss) from other rental activities				

Reviewing the taxpayer's Schedule K-1 is just the starting point. The Schedule K-1 is not always prepared correctly; therefore, it is helpful to review the PTE's return. It may be necessary to conduct an audit of the PTE.

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25 CCR § 17951-4(f) provides if a nonresident is a shareholder of an S corporation which carries on a unitary business, trade or profession within and without this state, the amount of a nonresident's pro rata share of S corporation income derived from sources within this state shall be determined in the same manner as if the S corporation were a partnership.

Nonbusiness Income

The PTE's nonbusiness income which flows through to a nonresident is sourced by the nonresident according to his/her personal sourcing rules (**CRTC § 17951-17955**). Generally…

- If the nonbusiness income is from an intangible, the income is allocated to the state of residence. Nonbusiness income from intangible can be CA source income if the intangible asset has developed a business situs in CA, see **CCR § 17952**.

- If the nonbusiness income is from tangible or real property, the income is allocated to the location of the property, see **CCR § 17951-3**.

Example 1

Mary is a resident of California and owns 25% of a California partnership which operates within and without California. The partnership reported business income from operations of $10,000,000, with a 10% California apportionment factor. Thus, the partnership apportions $1,000,000 in business income to California. Mary received a Schedule K-1 from the partnership which reflects the following:

(a) Distributive share items	(b) Amounts from federal Schedule K-1 (1065)	(c) California adjustments	(d) Total amounts using California law. Combine col. (b) and col. (c)	(e) California source amounts and credits
1 Ordinary income (loss) from trade or business activities	2,500,000	0	2,500,000	250,000

Column (d) – Mary's 25% distributive share of Partnership's business income from all sources:
$10,000,000 x 25% = $2,500,000

Column (e) – Mary's share of Partnership's income that is "CA Source." This amount is determined using Partnership's apportionment factor(s):

$2,500,000 (amount from column d) * 10% CA apportionment = $250,000

How much flow-through income should Mary report on her California resident return?

Determination:

California residents are taxable on their entire distributive share of flow-through income regardless of source. Thus, Mary's $2,500,000 distributive share of the partnership's business income is taxable by California. The amounts in Column (e) are irrelevant for resident taxpayers.

NOTE: Column (e) on the Schedule K-1 is not always filled out for California residents. However, sometimes partnerships DO complete it and you should remember these amounts are only applicable for nonresident partners.

Example 2

Same as Example 1 except that Mary is a nonresident of California.

How much California source income should Mary report on her California nonresident return?

Determination:

CCR § 17951-4(d)(2) provides that each partner's distributive share of the partnership business income apportioned to this state is income derived from sources within this state.

Column (d) – Mary's 25% distributive share of Partnership's business income from all sources:
$10,000,000 x 25% = $2,500,000

Nonresidents first compute tax as if they're a resident, thus, $2,500,000 will be included in Mary's "Adjusted Gross Income from All Sources" for purposes of determining her "Total Taxable Income" on her Form 540NR

Column (e) – Mary's share of Partnership's income that is "CA Source." This amount is determined using Partnership's apportionment factor(s):

$2,500,000 (amount from column d) * 10% CA apportionment = $250,000

Nonresidents are taxed on their actual "CA source" income and applying the effective CA tax rate; thus, $250,000 is included in Mary's CA taxable income.

Thus, Mary will include $250,000 as California source income, her share of the partnership's business income apportioned to California.

Example 3

Jeff is a nonresident of California and owns 50% of a California partnership which operates within and without California. The partnership reported a $2,000,000 capital gain from the sale of California real estate, which it reported as nonbusiness income. Jeff received a Schedule K-1 from the partnership which reflects the following:

(a) Distributive share items	(b) Amounts from federal Schedule K-1 (1065)	(c) California adjustments	(d) Total amounts using California law. Combine col. (b) and col. (c)	(e) California source amounts and credits
9 Net long-term capital gain (loss)	1,000,000	0	1,000,000	1,000,000

Column (d) – Jeff's 50% distributive share of Partnership's capital gain:
$2,000,000 x 50% = $1,000,000

Column (e) – Jeff's share of Partnership's capital gain that is "CA Source." In this example, the entire amount of the partnership's nonbusiness gain is allocated to California due to the property being located in California. Thus, Column (e) reflects the same amount as Column (d).

How much California source income should Jeff report on his California nonresident return?

Determination:

CCR § 17951-4(d)(4) provides that nonbusiness income is sourced according to the sourcing rules of **R&TC § 17951-17955**. Under **CCR § 17951-3**, the Regulation provides that income derived from real property located in this state is California source income. Thus, Jeff will include $1,000,000 as California source income, his share of the partnership's capital gain according to **CCR § 17951-4(d)(4)** and **§ 17951-3**.

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**.

Questions?

If you need additional help determining the source of a nonresident's flow-through income from PTEs, please talk to your lead and/or supervisor to request assistance from a PTE subject matter expert (SME).

3550 Trust Income

A trust is a legal entity which exists for the benefit of its beneficiaries. When a trust is required to distribute 100% of its current income to its beneficiaries (e.g. a "simple trust"), it will pay no tax itself and will be treated as a mere PTE, much like a partnership.

Thus, like a partnership, simple trusts flow through their income to the beneficiaries. Therefore, the rules determining the taxability of flow-through income from simple trusts are generally the same as partnership flow through income discussed in RSTM 3500.

Residents

California resident beneficiaries are taxable on their entire distributive share of flow-through income regardless of source. **CRTC § 17041(a) and (c)**.

Nonresidents

CRTC § 17953 provides trust income distributed or distributable to nonresident beneficiaries is income from sources within this state only if the income is derived from sources within this state. To determine whether the flow-through income is CA source income, nonresidents will follow the same rules set forth in RSTM 3500.

Grantor Trusts

Grantor Trusts are disregarded entities for income tax purposes under **IRC § 671-677**, CA conforms through **CR&TC § 17731**.

Therefore, the income to a Grantor Trust on Schedule K-1 from a PTE will be reported by the California resident grantor on his/her personal income tax return.

Non-resident individuals holding PTE interests through a grantor trust will report the amounts in Column d (Total Amounts Using California Law) on their CA 540NR form to compute their total taxable income. For purposes of determining their CA taxable income, nonresidents will report the amounts in column e (California Source Amounts) on their CA 540NR form.

3600 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, 2019, he sold a California rental property in an installment sale. During 2019 and 2020, he received installment proceeds comprised of capital gain income and interest income.

Determination:

The capital gain income is taxable by California in both 2019 and 2020 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, 2019, while a nonresident of California, Tim sold a Texas rental property in an installment sale. On May 15, 2020, he became a California resident and on August 1, 2020, 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, 2020, are taxable by California because Tim was a California resident when he received the proceeds.

Example 3

On September 1, 2016, while a nonresident of California, Bob sold stock (intangible property) in an installment sale. On June 1, 2018, he became a California resident. On October 1, 2018, 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, 2018, 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 2015, while a California resident, Beth sold a parcel of real property located in Washington in an installment sale. On March 1, 2018, she became an Ohio resident. On June 1, 2018, 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 2018, while a California resident, Rick sold a parcel of real property located in California in an installment sale. On June 1, 2020, he became a Washington resident. On August 1, 2020, 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.

Installment Sale of Intangible Property

CCR 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 2016, while a California resident, Alan sold stock (intangible property) in an installment sale. On February 1, 2019, he became a Florida resident, and on May 1, 2019, 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.

3650 Deferred Gains and Losses (like-kind exchanges)

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

California Property Exchanged for Out-of-State Property

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

Example 1

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

Determination:

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

Out-of-State Property Exchanged for California Property

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

Example 2

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

Determination:

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

Example 3

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

Determination:

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

3700 Tax Treaties with Foreign Countries

The U.S. Supreme Court has held that tax treaties entered into by the U.S. do not generally prohibit the taxing activities of sub-national governments, such as states. (See **Container Corp. v. Franchise Tax Bd. (1983) 463 U.S. 159, 196.**) The BOE has also declined to read any restrictions on California's ability to assess tax based on treaties between the U.S. and foreign countries when those treaties refer only to federal, not California, income taxes. (See **Appeal of de Mey van Streefkerk (85-SBE-135) 1985 WL 15915**.)

3750 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 2019, 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 12. Example One Solution

Taxable year 2019	Total taxable income	CA taxable income
CA Section 1231 gain	$3,000	$3,000
CA Section 1231 loss	(2,000)	(2,000)
WA Section 1231 gain	4,000	

Taxable year 2019	Total taxable income	CA taxable income
WA Section 1231 loss	(5,000)	
Capital gain	$0	$1,000

Example 2

Susan is a resident of Florida. In 2019, her California and non-California source Section 1231 gains and losses included a $2,500 California gain, a $3,000 California loss, a $1,000 Florida gain, and a $500 Florida loss.

Determination:

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

Taxable year 2019	Total taxable income	CA taxable income
CA Section 1231 gain	$2,500	$2,500
CA Section 1231 loss	(3,000)	(3,000)
FL Section 1231 gain	1,000	
FL Section 1231 loss	(500)	
Ordinary loss	$0	$(500)

3800 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 2019, 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 2019.

Determination:

Net Jill's capital gains and losses to determine the capital losses allowed in 2019 (the $3,000 limitation applies) and the capital loss carryover to 2020.

Taxable year 2019	Total taxable income	CA taxable income
CA capital gain	$2,000	$2,000
CA capital loss	(6,000)	(6,000)
NY capital gain	5,000	
NY capital loss	(2,000)	
Total	$(1,000)	$(4,000)
Capital loss allowed in 2019	$1,000	3,000
Capital loss carryover to 2020	$0	$(1,000)

Change of Residency to California (Move-In)

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

Example 2

Assume the same facts as Example 1. On January 1, 2020, Jill becomes a California resident. During 2020, 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 2019 capital loss carryover as if she had been a California resident for all prior years.

2019 Restatement	Total taxable income
CA capital gain	$2,000
CA capital loss	(6,000)
NY capital gain	5,000
NY capital loss	(2,000)
Total	$(1,000)
Capital loss allowed in 2019	$1,000
Capital loss carryover to 2020	$0

Step 2

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

Taxable year 2020	Total taxable income
CA capital loss	$(4,000)
WY capital gain	5,000
Capital loss carryover	0
Capital gain income	$1,000

Change of Residency from California (Move-Out)

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

Example 3

Assume the same facts as Examples 1 and 2. On January 1, 2021, Jill becomes a nonresident of California again. During 2021, 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.

2019 Restatement	Total taxable income	CA taxable income
CA capital gain	$2,000	$2,000
CA capital loss	(6,000)	(6,000)
NY capital gain	5,000	
NY capital loss	(2,000)	
Total	$(1,000)	$(4,000)
Capital loss allowed in 2019	$1,000	3,000
Capital loss carryover to 2020	$0	$(1,000)

2020 Restatement	Total taxable income	CA taxable income
CA capital loss, 2020	$(4,000)	$(4,000)
WY capital gain	5,000	

2020 Restatement	Total taxable income	CA taxable income
Capital loss carryover from 2019		(1,000)
Capital gain or loss	$1,000	$(5,000)
Capital loss allowed in 2020	$0	$3,000
Capital loss carryover to 2021	$0	$(2,000)

Step 2

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

Taxable year 2021	Total taxable income	CA taxable income
CA capital gain	$9,000	$9,000
CA capital loss	(5,000)	(5,000)
TX capital gain	8,000	
Total	$12,000	$4,000
Capital loss carryover from 2020	$0	(2,000)
Capital gain income	$12,000	$2,000

Part-Year Resident

If a taxpayer changes residency during the taxable year, compute income and deductions using resident rules for the period of the year the taxpayer was a California resident and nonresident rules for the period of the year the taxpayer was a nonresident. Compute any prior year carryover loss as if the taxpayer were a California resident for all prior years and as if the taxpayer were a nonresident for all prior years. Prorate both capital loss carryover amounts based upon the period of California residency and the period of nonresidency during the year.

Example 4

Peter became a California resident on July 1, 2019. His total and California source capital gains and losses for 2019 are as follows:

Before July 1, 2019	Amount	After July 1, 2019	Amount
Total capital gains	$10,000	Total capital gains	$8,000
CA source capital gains	7,000	CA source capital gains	4,000
Total capital losses	(2,000)	Total capital losses	(3,000)
CA source capital losses	(1,000)	CA source capital losses	(3,000)

His capital loss carryover from 2018 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.

Description	Amount
CA capital gains, before July 1, 2019	$7,000
CA capital losses, before July 1, 2019	(1,000)
Total capital gains, after July 1, 2019	8,000
Total capital losses, after July 1, 2019	(3,000)

Capital gain before carryover losses	$11,000

Step 2

Prorate Peter's capital loss carryover amounts based upon periods of California residency and nonresidency during 2019.

Period of Residency	Amount	Period of Nonresidency	Amount
2018 carryover, as if a CA resident for all prior years	$(7,000)	2018 carryover, as if a nonresident for all prior years	$(5,000)
CA resident days ÷ total days (184 ÷ 365)	X .5041	Nonresident days ÷ total days (181 ÷ 365)	X .4959
Prorated 2018 capital loss carryover	$(3,529)	Prorated 2018 capital loss carryover	$(2,479)

Step 3

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

Taxable year 2019	CA taxable income
Capital gain before carryover losses	$11,000
Capital loss carryover, resident period	(3,529)
Capital loss carryover, nonresident period	(2,479)
Capital gain, 2019	$4,992

3850 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.

See FTB Publication 1005, Pension and Annuity Guidelines, for more information.

3900 Royalties and Residuals

Generally, there are two types of royalties and residuals:

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

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

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

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

3910 Convenant Not to Compete - Sale of Business

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

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

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

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

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

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.

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:

The sale or disposition by a shareholder of substantially all of its shares in the corporation.

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.

3920 Alimony

Residents

Alimony received by a resident, whether paid by a nonresident or resident, is taxable. Alimony paid by a resident, even if paid to a nonresident, is deductible.

Nonresidents

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

For taxable years beginning prior to January 1, 2004:

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

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

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

Example 1

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

Determination:

Jeffrey computes his alimony deduction as follows:

California AGI/Total AGI =	$24,000/$240,000 =	10%
Alimony Paid X 10% =	$12,000 X 10% =	$1,200

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:

California AGI/Total AGI =	$100,000/$400,000 =	25%
Alimony paid during nonresidency period X 25%	$6,000 X 25% =	$1,500
Alimony paid during residency period + nonresidency =	$8,400 + $1,500 =	$9,900

3930 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.

3940 Net Operating Losses

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

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

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

- The amount of the loss attributable to the part of the taxable year in which the taxpayer was a resident.
- 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	Total Taxable Income	CA Taxable Income
NV business	$9,000	
CA business	(3,000)	(3,000)
Total	$6,000	$(3,000)

Determination:

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

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:	Total Taxable Income	CA Taxable Income
NV business	$150,000	
CA business		$1,000
Total	$150,000	$1,000

Taxable Year 2009:	Total Taxable Income	CA Taxable Income
NV business	$500,000	
CA business		$(200,000)

Total		$(200,000)

Taxable Year 2010:	Total Taxable Income	CA Taxable Income
NV business	$375,000	$100,000
CA business	$100,000	$100,000
Total	$475,000	

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:

Business Location	2003	2008	2009	2010
California		$250,000	$(25,000)	$15,000
Texas	$(125,000)	$300,000	$50,000	$5,000

Determination:

Step 1

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

2003 Restatement	Total Taxable Income
2003 NOL	$(125,000)
Allowable Percentage	X 60%
NOL carryover to 2003	$(75,000)

2008 Restatement:	Total Taxable Income
Business Income	$550,000
Prior NOL carryover	$(75,000)

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

2009 Restatement:	Total Taxable Income
Business Income	$25,000
Prior NOL carryover	(75,000)

2009 Restatement:	Total Taxable Income
NOL carryover to 2010	$(50,000)

Step 2

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

Taxable year 2010	Total Taxable Income
CA source income	$15,000
TX source income	5,000
Total	20,000
Prior year NOL carryover	(50,000)
NOL carryover to 2011	$(30,000)

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	Total Taxable Income	CA Taxable Income
Texas source business loss	$(125,000)	

CA NOL allowed percentage,	X 60%	
NOL carryover to 2004	$(75,000)	$0

2008 Restatement	Total Taxable Income	CA Taxable Income
TX source business income	$300,000	
CA source business income	250,000	$250,000
Total	$550,000	$250,000
Prior year NOL carryover	$(75,000)	$0

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.

2009 Restatement	Total Taxable Income	CA Taxable Income
TX source business income	$50,000	
CA source business income	(25,000)	$(25,000)
Total	25,000	$(25,000)
Prior year NOL carryover	$(75,000)	$0
Carryover to 2010	$(50,000)	$(25,000)

2010 Restatement	Total Taxable Income	CA Taxable Income
TX source business income	$5,000	
CA source business loss	15,000	$15,000
Total	20,000	15,000
Prior year NOL carryover	$(50,000)	$(25,000)
Carryover to 2011	$(30,000)	$(10,000)

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:

Before May 1, 2010	Amount	After May 1, 2010	Amount
WA business	$14,000	WA business	$(26,000)
CA business	(2,000)	CA business	10,000
Total	$12,000	Total	$(16,000)

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:

Step 1

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

Description	Amount
CA business losses, before May 1, 2010	$(2,000)
Total business losses, after May 1, 2010	(16,000)
Total	18,000
Current year NOL, 2010	$(18,000)

Step 2

Prorate Henry's NOL carryover amounts based upon periods of California residency and nonresidency during 2010

Period of Residency	Amount	Period of Nonresidency	Amount
NOL carryover, as if a CA resident for all prior years	$(6,000)	NOL carryover, as if a CA nonresident for all prior years	$(3,000)
CA resident days ÷ total days 245 ÷ 365	x .6712	Nonresident days ÷ total days 120 ÷ 365	x.3288
Prorated NOL carryover	$(18,000)	Prorated NOL carryover	$(986)

Step 3

Compute your prior year NOL carryover:

Description	Amount
NOL Carryover from prior years, resident period	$(4,027)
NOL carryover from prior years, nonresident	(986)

Description	Amount
period	
Total NOL carryover from 2010	$(5,013)

3950 Alternative Minimum Tax

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

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

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

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

California tentative minimum tax =

California alternative minimum taxable income X

(Total tentative minimum tax/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, 2016. Combined wages for the year totaled $170,000. Susan received $100,000 after her move to California. On October 1, 2016, 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

Description	Amount
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

Description	Amount
Total alternative minimum taxable income	$235,000
Less:Exemption amount	-65,114
	169,886
Alternative minimum tax rate	X .07
Total tentative minimum tax	$11,892

California alternative minimum tax adjusted gross income

Description	Amount
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

Description	Amount
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

Description	Amount
Total alternative minimum tax itemized deductions	$15,000
Multiply by the ratio:	

Description	Amount
CA alternative minimum tax adjusted gross income/Total alternative minimum tax adjusted gross income=	*$180,000/$250,000 = 72%*
Prorated alternative minimum tax itemized deductions	-10,800
California alternative minimum taxable income	$180,000 - $10,800 = $169,200

California alternative minimum tax

Description	Amount
California alternative minimum taxable income	$169,200
Multiply by the ratio:	
Total tentative minimum tax/Total alternative minimum taxable income=	*$11,892/$235,000 = 5.06%*
California tentative minimum taxable income	$8,561
Less: Prorated regular tax	-6,000
California alternative minimum tax	$2,561

3960 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 2019, he was not engaged in any passive activities. During 2019, Gary purchased rental properties in both California and Texas. In 2019, 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 2019 and suspended to 2020 as follows:

Taxable year 2019	Total taxable income	CA taxable income
CA rental income	$2,000	$2,000
CA rental losses	(30,000)	(30,000)
TX rental income	4,000	
Total	$(24,000)	$(28,000)
Allowed rental losses	24,000	25,000
Suspended loss to 2020	$0	$(3,000)

Example 2

Peggy has always been a resident of New York. Prior to 2019, she was not engaged in any passive activities. During 2019, Peggy became engaged in California and non-California passive activities. In 2019, 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 2020 as follows:

Taxable year 2019	Total taxable income	CA taxable income
CA partnership income	$2,000	$2,000
CA S-corporation loss	(8,000)	(8,000)
NY partnership income	3,000	
Suspended loss to 2020	$(3,000)	$(6,000)

Change of Residency to California (Move-in)

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

Example 3

Assume the same facts as Example 2. On January 1, 2020, Peggy becomes a California resident. In 2020, 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 2019 suspended passive loss as if she had been a California resident for 2019.

2019 Restatement:	Total taxable income
CA partnership income	$2,000
CA S corporation loss	(8,000)
NY partnership income	3,000

2019 Restatement:	Total taxable income
Suspended passive loss to 2020	$(3,000)

Step 2

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

Taxable year 2020	Total taxable income
CA partnership income	$3,000
CA S corporation loss	(1,000)
NY partnership income	7,000
Total	$9,000
Suspended passive loss, 2019	(3,000)
Passive income, 2020	$6,000

Change of Residency from California (Move-out)

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

Example 4

Assume the same facts as Examples 2 and 3. On January 1, 2021, Peggy becomes a nonresident of California again. During 2020, 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.

2019 Restatement	Total taxable income	CA taxable income
CA partnership income	$2,000	$2,000
CA S corporation loss	(8,000)	(8,000)
NY partnership income	3,000	
Suspended passive loss to 2020	$(3,000)	$(6,000)

2020 Restatement	Total taxable income	CA taxable income
CA partnership income	$3,000	$3,000
CA S corporation loss	(1,000)	(1,000)
NY partnership income	7,000	
Total	$9,000	$2,000
Suspended loss from 2019	(3,000)	(6,000)
Income or suspended loss, 2020	$6,000	$(4,000)

Step 2

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

Taxable year 2021	Total taxable income	CA taxable income
CA partnership income	$15,000	$15,000
CA S corporation loss	(7,000)	(7,000)
NY partnership income	2,000	
Total	$10,000	$8,000
Suspended loss from 2020	0	(4,000)
Passive income, 2021	$10,000	$4,000

Part-Year Resident

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

Example 5

George became a nonresident of California on October 1, 2018. His passive activities did not include any rental properties. His total and California source passive income and losses for 2018 were as follows:

Before October 1, 2018	Amount	After October 1, 2018	Amount
Total passive income	$13,500	Total passive income	$4,500
CA passive income	7,500	CA passive income	2,500
Total passive losses	(3,000)	Total passive losses	(1,000)

Before October 1, 2018	Amount	After October 1, 2018	Amount
CA passive losses	(6,000)	CA passive losses	(2,000)

George's suspended passive loss from 2017 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.

Description	Amount
Total passive income, before October 1, 2018	$13,500
Total passive losses, before October 1, 2018	(3,000)
CA passive income, after October 1, 2018	2,500
CA passive losses, after October 1, 2018	(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 2018.

Period of Residency	Amount	Period of Nonresidency	Amount
2017 suspended loss, as if a CA resident for all prior years	$(7,000)	2017 suspended loss, as if a nonresident for all prior years	$(5,000)

Period of Residency	Amount	Period of Nonresidency	Amount
CA resident days ÷ total days (273 ÷ 365)	X .7479	Nonresident days ÷ total days (92 ÷ 365)	X .2521
Prorated 2017 suspended loss	$(5,235)	Prorated 2017 suspended loss	$(1,260)

Step 3

Compute George's passive income or suspended loss for taxable year 2018.

Taxable year 2018	CA taxable income
Passive income before suspended losses	$11,000
Suspended passive loss, resident period	(5,235)
Passive loss, nonresident period	(1,260)
Passive income, 2018	$4,505

3970 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 (R&TC § 17951 – 17955) 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. Verify the double taxed income (DTI) has not been subtracted or otherwise excluded from California income.

- 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 § 18001** and **CCR § 18001-1**.

Example 1

John filed a California resident return for 2018. 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 2018 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 (CCR § 17951-5 provides wages are sourced to the state where services are performed) and the same wage income was taxed by both California and New York.

<u>Nonresidents</u>

For nonresidents of California to claim a credit:

- The tax must be paid to a state that allows California residents a credit against taxes imposed by that state. See California Schedule S for a listing of the applicable states.
- The income must have its source in California.
- 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 § 18002** and **CCR § 18001-2**.

Example 2

Susan filed a California nonresident return for 2018 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 2018 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's wages earned while working in California is California sourced income. The wages are taxable in California and are also taxed by Arizona since she is a resident of Arizona. Susan is allowed the other state tax credit because the same wage income was taxed by both California and Arizona.

Part-Year Residents

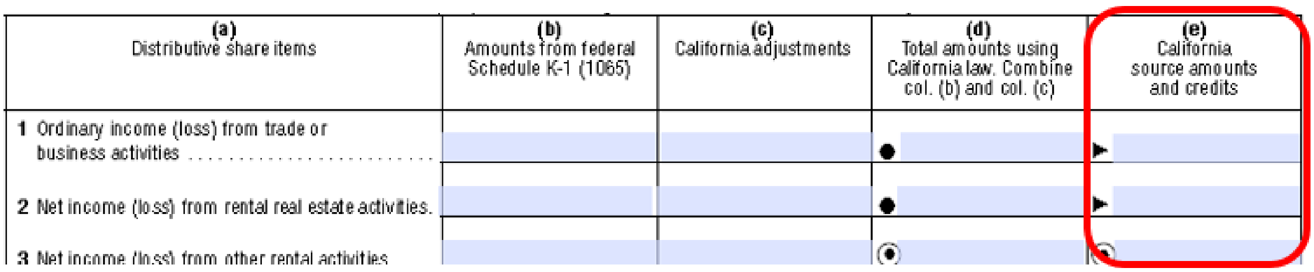
For part-year California residents to claim the credit:

- 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:

When DTI is pass-through income, the sourcing is done at the entity level. Thus, we need to review the entity return and Schedule K-1 to determine whether the entity apportions and/or allocates its income within and without California.

Pass-through entity (PTE) business income that is apportioned to CA and nonbusiness income allocated to CA has a source in CA (as shown on Schedule K-1, Column (e)).



(a) Distributive share items	(b) Amounts from federal Schedule K-1 (1065)	(c) California adjustments	(d) Total amounts using California law. Combine col. (b) and col. (c)	(e) California source amounts and credits
1 Ordinary income (loss) from trade or business activities				
2 Net income (loss) from rental real estate activities				
3 Net income (loss) from other rental activities				

If the PTE owner is a

- Resident: CA source income is **not** DTI and doesn't qualify for OSTC. Income that is properly sourced outside of CA and is DTI may qualify for the OSTC.
- Nonresident: CA source income should be reported on 540NR. For purposes of the OSTC, this is the amount of the DTI.

Remember – when determining the source of DTI, the sourcing rules may differ depending on whether the PIT earns the income (e.g. W-2 or 1099 income) or whether the income passes to the PIT from a PTE (e.g. K-1 pass-through income).

Example 3

Bob, a California resident, is a shareholder in XYZ Inc., an apportioning S Corporation located in Connecticut (CT). Bob received a W-2 from XYZ for wages of $500,000 for services Bob performed in California. Bob also received a Schedule K-1 from XYZ reflecting the following:

(a) Pro-rata share items	(b) Amount from federal Schedule K-1 (Form 1120-S)	(c) California adjustment	(d) Total amounts using California law. Combine col. (b) and col. (c) where applicable	(e) California source amounts and credits
1 Ordinary business income (loss)	2,475,000	25,000	2,500,000	1,000,000

As a California resident, Bob must include the $500,000 in wages and 100% of his $2,500,000 flow-through income from XYZ (Sch K-1 column d) as income on his resident return. Bob claims OSTC for double taxed income by CA and CT. When completing his California Schedule S, Bob includes the $500,000 in wages from XYZ and the $2,500,000 in S corporation income as DTI. Is this correct?

Determination:

No. For purposes of the OSTC, Bob needs to determine the amount of income that is sourced to CT using the CA nonresident sourcing rules (CCR § 17951-17955). Bob's $500,000 in wages is not DTI as the services were performed in California and properly sourced to CA under CCR § 17951-5. With regard to the flow-through income from XYZ, UDITPA rules are applied at the entity level and only business income apportioned to CT is sourced to CT. In this case, the K-1 shows Bob's share of XYZ's income apportioned to CA is $1,000,000 (Sch K-1 column e). Thus, the auditor should determine how much of the remaining $1,500,000 in income (column d – column e) is sourced to CT. If the entire $1,500,000 in income is properly apportioned to CT, Bob may include the $1,500,000 as DTI for purposes of computing the OSTC as long as Bob filed a return in CT and paid tax on the DTI.

Remember – often times the apportioning PTE will file returns in multiple states. The auditor should verify the PTE's income was properly apportioned outside of California and determine how much is apportioned to each state. Flow-through income apportioned outside of California may be included as DTI for purposes of computing the OSTC for each state as long as the taxpayer filed returns in those states and paid tax on the DTI in those states.

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 § 18006**.

Questions?

If you need additional help determining the taxpayer's OSTC when there is flow-through income from PTEs, please talk to your lead and/or supervisor to request assistance from a PTE subject matter expert (SME).

3980 Professional Athletes

RSTM 3985	Duty Day Allocations
RSTM 3990	Playing vs. Signing Bonuses
RSTM 3995	Endorsement Income

3985 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, 1987-SBE-026, April 7, 1987, the Board approved the use of the "duty days" method for professional athletes. "Duty days" generally include all working days from the beginning of official pre-season training through the last game in which the team competes. 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.

3990 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, 1984**). 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 that the contract was signed.

3995 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.

See **Goosen v IRS 136 TC 547** and **Garcia v IRS 140 TC 141**.

4000 RESIDENCY AND SOURCING AUDIT GUIDELINES

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
RSTM 4555	Lead Review
RSTM 4560	Financial Records
RSTM 4570	Physical Presence
RSTM 4580	Documenting the Audit
RSTM 4600	Making the Audit Determination
RSTM 4610	Summary of Facts
RSTM 4620	Determining Domicile
RSTM 4630	Determining Residency
RSTM 4640	Position Letter
RSTM 4650	Taxpayer's Position
RSTM 4660	Rebuttal to Taxpayer's Position
RSTM 4670	Rebuttal Letter
RSTM 4680	Alternative Position
RSTM 4700	Closing the Audit
RSTM 4710	Narrative Report
RSTM 4720	Case Review
RSTM 4730	Case Assembly

4100 Tax Forms and Reference Publications

Tax Forms

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	Reviewing Related Entity 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:

- DMV records.
- Internet.
- Lexis/Nexis.
- Zillow.com
- 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 Review 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. 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)
- Board of Equalization (BOE) decisions.
- Office of Tax Appeal (OTA) decisions.
- Court Cases.
- Legal Rulings.

Include a thorough research of tax and case law during your pre-audit analysis. Read Board of Equalization and OTA 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.

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.
- Type of return filed (resident, nonresident, part-year)

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:

	PASS Template	**Enclosure**
Residency Case	Initial Contact Ltr- Residency - FTB 1518B	Frequently Asked Questions About Your Residency Tax Audit - FTB 1015R
Sourcing Case	Initial Contact Ltr. to Individual - FTB 1517	Frequently Asked Questions About Your Tax Audit - FTB 1015B

Both letters should use a 30-day "reply by" date.

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 4555	Lead Review
RSTM 4560	Financial Records

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 Index to Audit File 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.

Contacting election offices (voter records) and out-of-state vehicle agencies (DMVs) are NOT considered Third-Party Contacts.

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. Subpoenas are rarely necessary and only used in the most extreme circumstances. 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.

4555 Lead Review

It is important to have your residency workpapers regularly reviewed to ensure the proper determination is made and to complete the examination on a timely basis. (Residency Subject Matter Experts (SMEs) may utilize peer review instead of the following items)

The auditor should request review from their lead before:

- Sending an Initial Contact Letter (ICL)
- Sending any Information Document Requests (IDRs)
- Having any financial information databased
- Creating any physical presence calendars or pivot tables
- Making the Audit Determination
- Drafting the Position Letter

4560 Financial Records

Financial records include the most useful, but most sensitive, documents obtained during a residency audit. Monthly bank statements, canceled checks, and credit card statements provide valuable information regarding the taxpayer's physical presence and extent of financial activities. Identify additional 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:

<u>Bank statements</u>

- Dates and locations of deposits, withdrawals, and wire transfers.
- Dates and locations of ATM, EFT, POS, and debit transactions.
- Physical Presence.
- 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).
- 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

- Dates and locations of transactions.
- Physical 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:

- 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.
- 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)
- 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.
- 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.
- 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, bank statements, 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.

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	Summary of Facts
RSTM 4620	Determining Domicile
RSTM 4630	Determining Residency
RSTM 4640	Position Letter
RSTM 4650	Taxpayer's Position
RSTM 4660	Rebuttal to Taxpayer's Position
RSTM 4670	Rebuttal Letter
RSTM 4680	Alternative Position

4610 Summary of Facts

Summarize each fact section and focus on only the most important connections within and outside of California.

Tax Return Filings

In this section, we summarize their California tax return filings and include if they filed/paid taxes to another state.

Residential Property

In this section, we summarize their real property with an emphasis on comparing their primary home in California with their claim state.

Investment Property (if applicable)

Briefly discuss any other real properties that taxpayer did not live in during your audit years (i.e. rentals, commercial property, etc).

Business/Employment

Discuss any significant business interests the taxpayer was involved in. What was their role with the company? Where was it headquartered? What other states/countries did the company operate? What was the taxpayers primary source of income?

Professional and/or Other Licenses (if applicable)

Briefly mention any professional license held during the audit years (real estate, medical, etc). Make sure to do research on both CA and the claim state to see if licenses are held in both states.

Driver's License

Brief sentence or two on whether they still held a valid CA drivers license, or if it was surrendered to claim state. Make sure to include any important dates and the location(s) of any traffic violations. Also consider what the other states requirements are to obtaining a drivers license. Did the taxpayer meet this criteria?

Personal Transportation

How many vehicles registered in CA compared to the claim state? Any vehicles purchased during the audit years? Any private aircraft and where was it hangared? Compare "vehicle expenses" from your financial database.

Voter Registration

Brief sentence or two on if they are still registered to vote in CA. Did they actually vote in CA? Was it in person or absentee? Address on file? Also for the claim state, did they register to vote? If so, what was the date of registration and address on file? Did they vote in person or absentee?

Club Memberships/Associations

Sentence or two on any significant memberships/associations maintained during the audit period. Also consider attendance logs for gyms, country clubs, etc.

Family

Any dependent children during audit years? Date of birth? Were they of school age? Where did they attend school? Daycare/preschool? Any children born during audit period? If so, which hospital? Any other relevant family members mentioned during audit to include here? Adult children? Where did they live? Elderly parents? Grandkids?

Pets

Did the financial database show any pet charges? If so, we can summarize them here.

Bank/Credit Card Accounts

Did the taxpayer keep their long standing bank accounts that were originally opened in CA? Did they open new bank accounts in their claim state? What were the mailing addresses on the statements?

Professionals

Summarize the medical/dental, legal/accounting, dry cleaning and salon/spa expenses here.

Transaction Totals

Summarize the total transactions in one sentence.

You may choose to omit certain transaction types to clear up any unknown locations (i.e. Financial, Online, Taxes, Unknown, or Utilities transaction types).

Everyday Expenses

Summarize the everyday expenses in one sentence.

This generally includes the following transaction types: Daily Living Expenses (groceries, pharmacies, etc), Dining, ATM, Entertainment, & Retail.

Physical Presence

Create a table to summarize the physical presence, then insert the calendars from the financial database.

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.

Analyze "Abandonment"

What did they continue to have/keep in CA? Still own the CA home? Still spending a significant amount of time in CA? Still working/CEO of CA business?

Analyze "Actually Residing"

Did they purchase/rent in claim state? Did they spend more time in CA than claim state? Focus on presence and use Whittel case.

Analyze "Intent"

This is where we acknowledge the connections they made in claim state. Intent must be supported by action.

4630 Determining Residency

If a taxpayer is domiciled in California, the facts must be examined to determine whether the taxpayer was outside of the state for a temporary or transitory purpose, such that the taxpayer will continue to be treated as a California resident. Whether an individual is outside California for a temporary or transitory purpose is a question of fact to be determined by examining all the circumstances of each particular case. The determination cannot be based solely on the individual's subjective intent but instead must be based on objective facts.

The underlying theory is that the state with which a person has the closest connection during the taxable year is the state of his or her residency. Therefore, in determining a taxpayer's residency, the contacts or connections a taxpayer maintains in California and other states are important factors to take into consideration.

Appeal of Bragg, supra, provides a list of nonexclusive objective factors to assist in determining which state an individual had the closest connection during the period in question. However, these factors serve merely as a guide, and **the weight given to any particular factor depends upon the totality of the circumstances**. The focus of the examination of these factors is to determine whether an individual is present for other than a temporary or transitory purpose, and to this end, satisfaction of a majority or a significant number of the factors is not necessarily dispositive. The residency factors can be organized into three categories, and will be analyzed as follows:

(The weight assigned to a particular connection can vary from case to case. These are suggestions based on what connections are "generally" weighted the highest and least.)

Highest Weight: Physical Presence, Residential Property, Spouse/Children/Pets, Business/Employment, Professional Services.

Moderate Weight: Everyday Expenses, Transaction Totals, Professional and/or Other Licenses, Club Memberships/Associations, Investment Property.

Least Weight: Bank/Credit Card Accounts, Tax Return Filings, Driver License, Personal Transportation, Voter Registration.

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 Board of Equalization or OTA 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.

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

If you have an electronic file, follow the Unit closing procedures checklist.

If you have a physical file, also follow the Unit closing procedures checklist and 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.