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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 18011233
	)	
JACKIE L. LOVATO AND	)	Date Issued: August 14, 2018
	)	
DIANE LOVATO	)	
	)	

OPINION

Representing the Parties:

For Appellants:	Jackie L. Lovato Diane Lovato
For Respondent:	Rachel Abston, Senior Legal Analyst
For Office of Tax Appeals:	Sheriene Anne Ridenour, Tax Counsel III

HOSEY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code Section 19045,[1] Jackie L. Lovato and Diane Lovato (appellants) appeal an action by the Franchise Tax Board (FTB or respondent) in proposing an assessment of $2,119 in additional tax, plus applicable interest, for the 2011 tax year.

Appellants waived their right to an oral hearing and therefore the matter is being decided based on the written record.

ISSUE

Whether appellants have established error in FTB's computation of tax liability pursuant to the process prescribed by Section 17041(b).

FACTUAL FINDINGS

1. Appellants filed a timely 2011 joint California income tax return (Form 540). On the return, appellants reported federal adjusted gross income (AGI) of $149,970, less

[1] Unless otherwise indicated, all "Section" references are to sections of the California Revenue and Taxation Code.

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California adjustments (subtractions) of $54,890 and itemized deductions of $16,015, for taxable income of $79,065. Appellants also reported exemption credits of $204.

2. Subsequently, FTB reviewed appellants' return and determined that appellants incorrectly subtracted "Wages, salaries, tips, etc." of $54,890 on Column B, line 7, of their Schedule CA (540). Specifically, FTB determined that appellants incorrectly subtracted their non-California sourced income in Column B, a column that is used when income is taxed differently for federal and state purposes, not when income is claimed to be sourced to another state. Consistent with appellants' use of Form 540, FTB also determined that appellants were residents of California and, therefore, were taxable on all their income.
3. As a result, FTB issued appellants a Notice of Proposed Assessment (NPA) on February 9, 2016. The NPA increased appellants' taxable income by $54,890, and proposed additional tax of $4,881, plus interest.
4. In response to the NPA, appellants paid the amount determined to be due from them, plus interest remitting a total of $5,351.44 to FTB on April 11, 2016. Simultaneously therewith, appellants also protested the NPA, asserting that they disagreed with the proposed assessment.
5. Due to a processing error by FTB, on or about August 12, 2016 the $5,351.44 amount appellants paid in response to the NPA, plus interest of $41.39, was erroneously refunded to appellants.
6. In the course of FTB's consideration of appellants' protest, appellants demonstrated that they were part-year California residents in 2011, having moved to this state in September of 2011. On August 22, 2016, FTB sent appellants a position letter which explained that for part-year residents, tax is calculated on the taxpayer's total taxable income and then multiplied by the ratio of the taxpayer's California AGI to AGI from all sources to arrive at the correct tax. FTB attached to its position letter a California nonresident or part-year resident income tax return (Form 540NR) to demonstrate the calculations for appellants' 2011 tax year. The letter indicated that based on the part-year residency calculations, FTB would reduce the proposed additional tax to $2,119, plus interest.
7. FTB issued a Notice of Action (NOA) reflecting the revised proposed assessment of $2,119, plus interest. This timely appeal followed.

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DISCUSSION

FTB's determinations are presumed correct and a taxpayer has the burden of proving it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.)[2]

California residents are taxed upon their entire taxable income (regardless of source), while nonresidents are only taxed on income from California sources. (§ 17041(a), (b), and (i); § 17951.) Part-year residents are taxed on their income earned while residents of this state, as well as all income derived from California sources. (§ 17041(b) & (i).) The rate of tax on part-year residents is determined by taking into account the taxpayer's worldwide income. (*Appeal of Louis N. Million*, 87-SBE-036, May 7, 1987.) This method, known as the "California Method," does not tax out-of-state income received while a taxpayer is not a resident of California, but merely takes the out-of-state income into consideration in determining the tax rate that should apply to California-source income. (*Id.*) The purpose of the California Method is to apply the graduated tax rates to all persons, not just those who reside in California.[3] The progressive (graduated) tax rates are designed to apportion the tax burden based on ability to pay.

For the year at issue, California law requires the calculation of three ratios to be applied in determining (1) a part-year resident's prorated deductions, (2) tax rate applicable to the taxpayer's California taxable income, and (3) allowable credits, as follows:

1. Prorated Deductions: To calculate the percentage of itemized deductions or prorated standard deduction allowable, a taxpayer must divide California AGI by total AGI. The resulting ratio is then applied to the itemized deductions or standard deduction to find the prorated allowable amount. (§ 17304.)

[2] Pursuant to the Office of Tax Appeals Rules for Tax Appeals, precedential opinions of the State Board of Equalization (BOE) that were adopted prior to January 1, 2018, may be cited as precedential authority to the Office of Tax Appeals unless a panel removes, in whole or in part, the precedential status of the opinion. (California Code of Regulations, title 18, § 30501, subd. (d)(3).) The BOE's precedential decisions may be accessed at http://www.boe.ca.gov/legal/legalopcont.htm.

[3] The fundamental fairness and the constitutionality of using out-of-state income to calculate the rate of tax has been upheld by New York's highest court, and the United States Supreme Court refused to hear an appeal from the New York decision. (*Brady v. New York* (1992) 80 N.Y.2d 596, cert. den. (1993) 509 U.S. 905.) The *Brady* court reasoned that similarly-situated taxpayers were those with the same total income. For example, a nonresident earning $20,000 in New York, but with $100,000 of reported total income, should be taxed on the $20,000 of New York-source income at the same rate as a New York resident with $100,000 of total income (and not at the same rate as a New York resident with $20,000 of total income).

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2. Tax Rate. To calculate the tax rate for California, the tax on the total taxable income is calculated as if the taxpayer was a California resident, and then divided by the taxpayer's total taxable income. The resulting rate is then applied to the taxpayer's California taxable income to determine the California tax. (§ 17041(b)(2).)

3. Prorated Credits. To calculate the percentage of credits allowed on a part-year resident's California return, the California taxable income is divided by the total taxable income. The resulting rate is then applied to the total exemption amount to find the prorated credits. (§ 17055.)

In reviewing FTB's calculations on the Form 540NR it prepared for this matter, we conclude the calculations are consistent with the law described above. The Form 540NR shows appellants' federal AGI (as well as their AGI from all sources) of $149,970, less itemized deductions of $16,015, for a revised total taxable income of $133,955 and tax of $7,754. Appellants' California AGI is $95,080, their California taxable income is $84,926 ($95,080 minus prorated itemized deductions of $10,154 (i.e., $16,015 x 0.6340)[4]), and their California tax rate is 0.0579. This rate is calculated by dividing the $7,754 tax on total taxable income by $133,955 to reach the 0.0579 graduated tax rate to apply to appellants' $84,926 of California taxable income. Thus, appellants' total taxable income was used only as the denominator to determine the graduated tax rate to be applied to their California taxable income. The $4,917 tax (i.e., $84,926 x 0.0579) less the $129 prorated exemption credit (i.e., $204 x 0.6340)[5], arrives at a corrected tax of $4,788. After applying $2,669 in taxes appellants remitted with their original Form 540, the revised tax due is $2,119, which is the amount reflected on the NOA.

Appellants assert that they disagree with the proposed assessment and attach a completed Form 540NR for 2011 to their appeal letter. On that form, appellants reported federal AGI of $149,970, less California adjustments (subtractions) of $54,890, for an AGI from all sources of $54,741. However, as explained above, all of appellants' 2011 income must be reported since their income from all sources is used to calculate the tax rate that applies to appellant's

[4] The percentage of deductions allowed was calculated by dividing the appellants' California AGI of $95,080 by the couple's total AGI of $149,970.

[5] The percentage of credits allowed was calculated by dividing the appellants' California taxable income of $84,926 by the couple's total taxable income of $133,955.

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California-sourced income. On the Form 540NR proffered by appellants, they incorrectly subtracted $54,890 from their federal AGI in calculating their AGI from all sources. Appellants have not produced any evidence to show error in either the proposed assessment or FTB's application of the formula set forth in section 17041(b).

Appellants have not raised any allegations of error with respect to FTB's having made an erroneous refund of the amount they paid in satisfaction of the tax deficiency determined for 2011. Nevertheless, we note that section 19368 provides that, if FTB makes or allows a refund that it later determines to be erroneous, in whole or in part, the amount erroneously made or allowed may be assessed and collected after notice and demand pursuant to section 19051 (pertaining to mathematical errors), except that the rights of protest and appeal shall apply with respect to amounts assessable as deficiencies without regard to the running of any period of limitations. The notice and demand for repayment must be made within two years after the refund or credit was made or allowed, or during the period within which FTB may mail a notice of deficiency assessment, whichever is later. (§ 19368.) Section 19104(c) states that FTB shall abate the interest on an erroneous refund amount until 30 days after the date demand for repayment is made.

Here, FTB erroneously refunded the original assessment on August 12, 2016, and made a demand for repayment in its opening brief on May 11, 2017. FTB gave appellants notice well within the allotted time period and has indicated that it will abate interest on the erroneous refund from August 12, 2016 (the date of the erroneous refund) to June 10, 2017 (30 days after the May 11, 2017 demand for repayment), as required by section 19104(c).

HOLDING

Appellants have not established error in FTB's computation of tax liability pursuant to the California Method as prescribed by section 17041(b).

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DISPOSITION

Respondent's action on appellants' protest of the proposed assessment for the year 2011 is sustained, including the abatement of interest on the erroneous refund from August 12, 2016 to June 10, 2017 as required by section 19104(c).

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Sara A. Hosey
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Sara A. Hosey
Administrative Law Judge

We concur:

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Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

DocuSigned by:
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Alberto T. Rosas
Administrative Law Judge