OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18042990
OWAIS KAZI AND SURWAT KAZI	) Date Issued: July 23, 2019

OPINION

Representing the Parties:

For Appellants: Muhammad Khilji, CPA

For Respondent: Eric R. Brown, Tax Counsel III

For Office of Tax Appeals: Andrew Jacobson, Tax Counsel III

S. HOSEY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19045, Owais Kazi and Surwat Kazi (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing an additional tax of $2,888[1] and a late-filing penalty of $722, plus applicable interest, for the 2013 tax year.

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

ISSUES

1. Whether FTB erred in computing appellants' 2013 California income tax using the method prescribed by R&TC section 17041(b).
2. Whether appellants' failure to timely file a tax return for the 2013 tax year was due to reasonable cause and not due to willful neglect.

[1] FTB concedes that the proposed additional tax of $2,888 shown on the Notice of Action (NOA) was computed in error and the correct amount of additional tax is $2,954. However, FTB has stated that it will not increase the proposed assessment.

FACTUAL FINDINGS

1. Prior to the year at issue, appellant-husband left his California home for an overseas employment assignment, while appellant-wife remained in California.[2] Appellant-husband lived in Karachi, Pakistan during 2013,[3] where he was employed as an executive with Karachi International Containers Terminals (KICT).
2. Appellants did not file a timely 2013 California income tax return. By a Request for Tax Return dated April 21, 2015, FTB requested that appellants show that they had already filed a 2013 return, file a 2013 return, or explain why no return was required by no later than May 27, 2015.
3. On May 30, 2015, appellants filed an untimely 2013 California Resident Income Tax Return (FTB Form 540), using the married filing jointly filing status. On their California return, appellants reported federal adjusted gross income (AGI) of $83,756, California AGI of $80,583, itemized deductions of $33,080, taxable income of $47,503, a tax of $1,029 and exemption credits of $1,190. Because their exemption credits of $1,190 exceeded their tax of $1,029, appellants reported a zero-balance due.
4. Appellants filed a 2013 federal income tax return (IRS Form 1040), using the married filing jointly filing status. Appellants attached to their federal return an IRS Form 2555, *Foreign Earned Income*, on which they reported that appellant-husband received foreign earned income of $130,523 in 2013 in connection with his employment with KICT and claimed a foreign earned income exclusion of $97,600. In response to questions on the Form 2555, appellants stated that appellant-husband lived in Pakistan from December 18, 2012 through March 13, 2015, his family did not live with him, and appellant-husband maintained a home in the United States that was located at an address in Irvine, California.
5. FTB audited appellants' 2013 return and determined that appellants erroneously excluded foreign earned income of $96,700 from their California return.

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[2] There are inconsistencies in the record regarding whether appellant-husband left California for Pakistan in August of 2011 or in December of 2012. Regardless, it is clear that appellant-husband's overseas employment lasted for all of 2013.

[3] There are inconsistent statements in the record regarding appellant-husband's location in 2013. Appellants state that appellant-husband was not in California at all during 2013 and that appellant-husband was in California for 20 days. However, the number of days appellant-husband was in California is inconsequential for purposes of our analysis herein.

6. On November 21, 2017, FTB issued a Notice of Proposed Assessment (NPA), which increased appellants' taxable income from their reported $47,503 to $144,203 by adding back the excluded foreign earned income of $96,700. FTB proposed an additional tax of $7,346 and imposed a late-filing penalty of $1,836.50, plus applicable interest.
7. In a letter dated November 30, 2017, appellants protested the NPA, asserting that their foreign earned income should not be taxable for California purposes because appellant-husband was employed in Pakistan and was located physically outside the United States for a period spanning prior to and after the year at issue.
8. In a letter dated December 26, 2017, FTB stated that, because appellant-husband had resided and worked outside the United States throughout 2013, appellant-husband was a nonresident and appellants should have filed a FTB Form 540NR (Nonresident or Part-Year Resident) return for 2013 instead of a FTB Form 540 (Resident) return. FTB attached a Corrected 2013 FTB Form 540NR (FTB's Corrected Return), which showed a total California tax of $2,954.
9. In a letter dated January 17, 2018, appellants asserted that they "have an agreement that all wages earned by [appellant-husband] belong to him in full and are not community property, as is allowed under [IRC] Section 66(c)."
10. In a letter dated February 21, 2018, appellants asserted that they erroneously reported duplicate income of $24,723 on their Schedule CA. Appellants attached a schedule in support of their calculations.
11. On March 8, 2018, FTB issued a NOA that modified the NPA in response to appellants' protest. The NOA reduced the proposed assessment of tax from $7,346 to $2,888 and the proposed late-filing penalty from $1,836.50 to $722. This timely appeal followed.

DISCUSSION

Issue 1 – Whether appellants have established that FTB erred in computing their 2013 California income tax, using the method prescribed by R&TC section 17041(b).

Foreign Earned Income

Internal Revenue Code (IRC) section 911 allows taxpayers to exclude from federal gross income a limited amount of earned income from foreign sources. California law, however, specifically provides that California does not conform to IRC section 911. (R&TC,

§ 17024.5(b)(8).) Therefore, appellants have no legal basis to apply IRC section 911 to exclude appellant-husband's foreign earned income from their 2013 California taxable income.

Community Property

California residents are taxed upon their entire taxable income (regardless of source), while nonresidents are only taxed on income from California sources. (R&TC, §§ 17041(a), (b), & (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. (R&TC, § 17041(b) & (i).) R&TC section 17014(a) provides that the term "resident" includes: (1) every individual who is in California for other than a temporary or transitory purpose; and (2) every individual domiciled in California who is outside California for a temporary or transitory purpose. Thus, an individual domiciled in California remains a resident unless he or she leaves for other than a temporary or transitory purpose. (Cal. Code Regs., tit. 18, § 17014.) The California Court of Appeal and the California Code of Regulations define "domicile" as the location where a person has the most settled and permanent connection, and the place to which a person intends to return when absent. (*Whittell v. Franchise Tax Bd.* (1964) 231 Cal.App.2d 278, 284; Cal. Code Regs., tit. 18, § 17014(c).)

FTB conceded at protest that appellant-husband was not a resident of California during 2013 pursuant to R&TC section 17014(a). It is also undisputed that appellant-wife was a resident of California during 2013. However, in order to attribute one-half of appellant-husband's income to appellant-wife, we must first determine if appellant-husband was domiciled in California, a community property state.

Appellant-husband states he went overseas for an employment assignment sometime during 2011 or 2012. From this statement, we can infer that appellant-husband was domiciled in California prior to leaving for his overseas employment. Appellant-husband left California for the work assignment, which was to last several years, if not indefinitely. However, appellant-husband retained ties to California, most notably his wife and three sons. The maintenance of a marital abode is a significant factor in resolving the question of domicile. (*Appeal of Harrison* (85-SBE-059) 1985 WL 15838). Based on this evidence, we find that while appellant-husband's extended absence from California severed his California residency, he always intended to return to California to be with his family, and thus remained a California domiciliary during the year at issue. (*Ibid*; see also *Appeal of Gabrik* (86-SBE-014) 1986 WL 22686 [finding taxpayers

domiciled in California while working overseas, in part, because their children remained in California, they held real property in California, and they claimed the California homeowner's exemption]; *Appeal of Zupanovich* (76-SBE-002) 1976 WL 4018 [finding taxpayer domiciled in California while working overseas, in part, because his wife and daughter rented a home in California, and his mother and two married children lived in California]; *Appeal of Broadhurst* (76-SBE-036) 1976 WL 4052 [finding taxpayer domiciled in California while working overseas, in part, because his wife and children lived in California]; cf. *Appeal of Hardman* (75-SBE-052) 1975 WL 3536 [finding taxpayers not domiciled in California, in part, because whole family moved overseas and children enrolled in foreign schools].)

Next, we must also determine whether appellant-wife had a community property interest in appellant-husband's 2013 income from KICT. In California, all property acquired during marriage is presumptively community property. (Fam. Code, § 760.) Family Code section 770 provides that the separate property of a married person includes all property owned by the person prior to marriage and the rents, issues, and profits of such property. (Fam. Code, § 770(a)(1), (a)(2).) The character of the property as separate or community property is fixed as of the time the property is acquired; and the character continues until it is changed in some manner recognized by law, as by agreement by the parties. (*In re Marriage of Rossin* (2009) 172 Cal.App.4th 725, 732.)

A spouse residing in a community property state is liable for tax on one half of the income realized by the community during its existence; spouses filing separate returns must each report one half of the community income. (*United States v. Mitchell* (1971) 403 U.S. 190; 196-97; *Appeal of Elzey* (74-SBE-030) 1974 WL 2845.) However, California permits agreements between spouses (including prenuptial agreements) to transmute community property into separate property. (Fam. Code, § 850(a).) A transmutation of real or personal property is not valid unless made in writing by an express declaration that is made, joined in, consented to, or accepted by the spouse whose interest in the property is adversely affected. (Fam. Code, § 852(a).) Transmutation agreements do not affect the law governing characterization of property in which separate property and community property are commingled or otherwise combined. (Fam. Code, § 852(d).) All income received after the execution of a transmutation agreement (or a prenuptial or postnuptial agreement) shall be taxed only to the spouse who

receives it as separate property. (See *Van Dyke v. Commissioner* (9th Cir. 1941) 120 F.2d 945, 947*; Helvering v. Hickman* (9th Cir. 1934) 70 F.2d 985, 986.)

An individual's marital property interest in personal property is governed by the laws of the acquiring spouse's domicile. (*Schecter v. Superior Ct.* (1957) 49 Cal.2d 3, 10; *Appeal of Scott* (81-SBE-020) 1981 WL 11747.) The non-California source income of a nonresident spouse who is domiciled in California is community property under California law and the other spouse, who is a California resident, is liable for the California income tax on his or her one-half community property interest in that income. (*Appeal of Bailey* (76-SBE-016) 1976 WL 4032; see also Fam. Code, § 760.)

Appellants have failed to show that appellant-husband's foreign earned income was appellant-husband's separate property, rather than the community property of appellant-husband and appellant-wife. Appellants assert that they agreed that appellant-husband's wages, including the income he earned in Pakistan during 2013, was his separate income. However, there is no proof in the record of any prior written agreement between appellant-husband and appellant-wife severing community property interests that would have been valid during 2013. Appellants have failed to produce a copy of a writing, which is required in order for us to find that appellants had a valid transmutation agreement. (Fam. Code, § 852(a).)

Appellants erroneously contend that they can exclude appellant-husband's foreign earned income from their California income based on the holding in *Lucas v. Earl* (1930) 281 U.S. 111 (*Lucas*). *Lucas* dealt with the assignment of income doctrine, which provides that income is ordinarily taxed to the person who earns it, and that the incidence of income taxation may not be shifted by anticipatory assignments. (*Id*. at pp. 114-115. See also *Commissioner v. Culbertson* (1949) 337 U.S. 733, 739-40.) *Lucas* stands for the proposition that an anticipatory assignment of income between a husband and a wife is invalid for tax purposes. (*Lucas, supra,* 281 U.S. at pp. 114-15.) It does not state that California community property laws are inoperative, as appellants appear to argue. In any case, *Lucas* dealt with an executed written agreement between a husband and a wife. Here, however, appellants have provided no proof that they ever executed such an agreement.

Appellants also assert that appellant-husband's foreign earned income should not be taxable by California pursuant to IRC section 879, as well as IRS Revenue Ruling 68-66. IRC section 879(a) provides that in the case of a married couple one or both of whom are nonresident

alien individuals and who have community income for the taxable year, earned income (within the meaning of IRC section 911(d)(2)), shall be treated as the income of the spouse who rendered the personal services. However, California does not conform to IRC section 879. The version of R&TC section 17024.5 (b)(11) that was in effect during 2013 stated: "Unless otherwise specifically provided, when applying any provision of the Internal Revenue Code for purposes of this part, a reference to [nonresident aliens] is not applicable for purposes of this part." Therefore, California does not conform to IRC, subchapter N, part II, *Nonresident Aliens and Foreign Corporations*, which includes IRC section 879.

Finally, appellants' reliance on Revenue Ruling 68-66 is also without merit. This ruling concludes that community property is excluded from the income of a non-earning spouse when for all intents and purposes a marriage has been terminated in the State of Washington, but not legally dissolved, and the spouses show by affirmative action their intent not to maintain the community status. Revenue Ruling 68-66 is based on an examination of Washington community property laws and its conclusion is limited to marriages terminated in the State of Washington. In any event, appellants have offered no evidence to suggest the marital community ended in 2013 or at any other time.

Accordingly, we hold appellants have failed to show that FTB erred by taxing one-half of appellant-husband's income received from KICT in Pakistan as appellant-wife's community property.

California Method of Taxation for Nonresidents and Part-Year Residents

The rate of tax on part-year residents is determined by taking into account the taxpayer's worldwide income. (*Appeal of Million* (84-SBE-036) 1987 WL 5953.) 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. (*Ibid.*) The purpose of the California Method is to apply the graduated tax rates to all persons, not just those who reside in California. 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) the 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 the 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. (R&TC, § 17304.)
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. (R&TC, § 17041(b)(2).)
3. Allowable 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. (R&TC, § 17055.)

After reviewing the NOA and FTB's Corrected Return, we find that the resulting tax due of $2,888 is consistent with the law described above. For 2013, appellant-husband was a nonresident of California, and was required to file a California Nonresident Return so that the California Method of computing a nonresident's tax liability can be applied to calculate the correct California income tax pursuant to R&TC section 17041(b).

On their 2013 return, appellants excluded $96,700 of appellant-husband's $130,523 foreign earned income. On the FTB's Corrected Return, FTB adds back California adjustments (in this case, the foreign earned income) of $97,600 to appellants' federal AGI, which, when combined with appellants' other income and deductions, results in a total taxable income of $119,480. FTB includes all of appellant-husband's foreign earned income of $130,523 on line 7, column D of the Schedule CA (540NR), then halves this amount so that only appellant-wife's one-half community property portion of $65,262 is included in appellants' California AGI of $89,299. FTB subtracts pro-rated California deductions of $19,362 to compute a California taxable income of $69,937, which results in a tax of $6,237. FTB calculates a California tax rate of .0522 by dividing the tax of $6,237 by the total taxable income of $119,480. FTB then multiplies appellants' California taxable income of $69,937 by the California tax rate of .0522, which results in a California tax before exemption credits of $3,651, which is reduced by

California prorated exemption credits of $697, resulting in a total tax due of $2,954.[4] Because FTB has supported its computation with appellants' actual items of income, FTB has complied with the requirements of the California method prescribed pursuant to R&TC section 17041(b). Therefore, appellants have failed to show that FTB erred in calculating their 2013 tax liability using the California Method pursuant to R&TC section 17041(b).

Issue 2 – Whether appellants have established that their failure to timely file a tax return for the 2013 tax year was due to reasonable cause and not due to willful neglect.

California imposes a penalty for the failure to file a return on or before the due date, unless it is shown that the late filing is due to reasonable cause and not due to willful neglect. (R&TC, § 19131.) The penalty is computed at five percent of the amount of tax required to be shown on the return for every month that the return is late, up to a maximum of 25 percent. (R&TC, § 19131(a).)

A taxpayer has the burden of establishing reasonable cause. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001- SBE- 001) 2001 WL 37126924.) As a general matter, in order for a taxpayer to establish that a failure to act was due to reasonable cause, the taxpayer must show that the failure occurred despite the exercise of ordinary business care and prudence, or that cause existed as would prompt an ordinarily intelligent and prudent businessperson to have so acted under similar circumstances. (*Appeal of Bieneman* (82-SBE-148) 1982 WL 11825; *Appeal of Tons* (79-SBE-027) 1979 WL 4068.) Ignorance of the law does not excuse the filing of a late return. (*Appeal of Diebold, Inc.* (83-SBE-002) 1983 WL 15389; *Appeal of Morris and Forbes* (67-SBE-042) 1967 WL 1384.)

Appellants' 2013 return was due on April 15, 2014, but they did not file it until May 30, 2015. Appellants do not dispute the computation of the late-filing penalty. Appellants do not raise any reasonable cause arguments, nor do they provide any evidence relative to their failure to file a timely 2013 return. Therefore, we find that appellants have not shown that their failure to timely file a 2013 personal income tax return was due to reasonable cause.

[4] FTB states that the tax due of $2,888 listed on the NOA was computed in error based on an added-back foreign earned income of $96,700 instead of the $97,600 shown on the appellants' federal return. It appears that this inversion was the fault of appellants, who subtracted $96,700 from their original 2013 return, Schedule CA 540 in Column B, line 21f, then added foreign earned income of $97,600 in Column C, line 21f.

HOLDINGS

1. Appellants have not established that FTB erred in computing their 2013 tax liability using the method prescribed by R&TC section 17041(b).
2. Appellants have not established that their failure to timely file a tax return for the 2013 tax year was due to reasonable cause and not due to willful neglect.

DISPOSITION

FTB's action is sustained in full.

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Sara A. Hosey
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Sara A. Hosey
Administrative Law Judge

We concur:

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Patrick J. Kusiak
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Patrick J. Kusiak
Administrative Law Judge

DocuSigned by:
John O Johnson
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John O. Johnson
Administrative Law Judge