

3. When processing appellant's return, FTB determined that appellant incorrectly filed a Form 540, as opposed to a California Nonresident or Part-Year Resident Income Tax Return (Form 540NR), as well as incorrectly calculated her tax liability. Specifically, FTB determined that appellant incorrectly subtracted her non-California sourced income from her federal AGI using Schedule CA (540), which is a schedule used when income is taxed differently for federal and state purposes.
4. As a result, FTB sent appellant a Notice of Proposed Assessment (NPA), dated December 27, 2019. The NPA increased appellant's total taxable income to \$111,045, and proposed additional tax of \$1,533, plus interest. To demonstrate FTB's computation of appellant's revised tax liability for the 2015 tax year, FTB included with the NPA: (1) a document titled "Nonresident/Part-Year Resident Rate Computations Schedule for Taxable Year Ending: 12/2015"; (2) and a prepared Form 540NR for reference, reporting federal AGI of \$148,355, California adjustments (subtractions) of \$29,222,² AGI from all sources of \$119,113, total taxable income of \$111,045, California taxable income of \$22,924, tax of \$1,567 (before applying the tax of \$34 appellant paid), and additional tax of \$1,533 (i.e., \$1,567 - \$34).
5. Appellant protested the NPA, asserting that while she originally filed the incorrect return, she nevertheless did not have an outstanding tax liability. Appellant included with her protest a 2015 Form 540NR, reporting federal AGI of \$148,355, California adjustments (subtractions) of \$123,762, AGI from all sources of \$24,593, total taxable income of \$16,523, and zero tax due. Appellant included with the Form 540NR a 2015 Schedule CA (540NR) reporting \$24,593 of "Rental real estate, royalties, partnerships, S corporations, trusts, etc." on line 17 column D ("Total Amounts Using CA Law As If You Were a CA Resident").³
6. In response to appellant's protest, FTB sent appellant a letter indicating that FTB found the Form 540NR appellant included with her protest letter to be incorrect. The letter explained that California adjustments (subtractions) are used only to report differences

² This amount consists of \$11 in taxable interest and \$29,211 in social security benefits.

³ We note that two tax preparers from H&R Block separately prepared appellant's Form 540 and Form 540NR, the latter of whom also filed appellant's protest letter on her behalf. Thus, although appellant sought professional assistance from H&R Block in preparing both returns, the calculation of tax is nevertheless incorrect, as discussed below.

between federal and state tax laws, and that for California nonresidents, tax is calculated on total taxable income and then multiplied by the ratio of California AGI to AGI from all sources to arrive at the correct tax.

7. FTB issued a Notice of Action (NOA), dated October 8, 2020, affirming the NPA.
8. This timely appeal followed.

DISCUSSION

California residents are taxed upon their entire taxable income (regardless of source), while nonresidents, such as appellant, are only taxed on income from California sources. (R&TC, §§ 17041(a), (b), & (i); 17951.)

The calculation of the tax rate on a nonresident, which is statutorily required by R&TC section 17041(b), is part of a multistep process known as the “California Method.” Under the California Method, the rate of tax that is applied to the income of a nonresident that is subject to California taxation is determined by taking into account the taxpayer’s worldwide income for the entire tax year. (*Appeal of Million* (87-SBE-036) 1987 WL 59534.) This method does not tax out-of-state income received while a taxpayer is not a resident of California, but merely takes into account a taxpayer’s “entire taxable income” for the year, including income from non-California sources, in determining the applicable tax rate. (R&TC, § 17041(b)(2).) The tax rate so determined is then applied only to the nonresident taxpayer’s California sourced income. The purpose of the California Method is to apply the graduated tax rates to all persons, not just those who reside in California.

For the year at issue, California law requires the calculation of three ratios to be applied in determining (1) a nonresident’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 AGI from all sources. 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, a taxpayer must divide the tax on the total taxable income (calculated as if the taxpayer was a California resident) 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. Prorated Credits. To calculate the percentage of credits allowed on a nonresident's California return, a taxpayer must divide the California taxable income by the total taxable income. The resulting rate is then applied to the total credit amount to find the prorated credits. (R&TC, § 17055.)

In reviewing FTB's calculations on the Form 540NR it provided with the NPA, the calculations are consistent with the law described above. The Form 540NR shows appellant's federal AGI as \$148,355, less California adjustments (subtractions) of \$29,222, for a revised AGI from all sources of \$119,133, and, after applying itemized deductions of \$8,088,⁴ a revised total taxable income of \$111,045 and tax of \$7,804. Appellant's California AGI is \$24,593, California taxable income is \$22,924,⁵ and her California tax rate is 0.0703. This rate is calculated by dividing tax of \$7,804 by the total taxable income of \$111,045; thus, appellant's total taxable income was used *only* as the denominator to determine the graduated tax rate to be applied to her California taxable income. The tax of \$1,612 (i.e., \$22,924 x 0.0703) less the \$45 prorated exemption credit (i.e., \$218 x 0.2064)⁶ arrives at a corrected California tax of \$1,567,⁷ as reflected on the NPA. The NPA reflects a total California tax of \$1,567, less the \$34 in taxes appellant previously remitted, for an additional tax of \$1,533, as affirmed by the NOA.

Appellant argues that FTB, in calculating the proposed assessment, does not consider that appellant was a nonresident of California during 2015, and that her "only income from California" was \$24,593. As such, appellant concedes on appeal, as well as reported on both her Form 540 and Form 540NR, that she received California sourced income during 2015. Appellant's California sourced income is subject to California state income tax, regardless of her residency. (R&TC, §§ 17041(a), (b), & (i); 17951.) On the Form 540NR appellant provided with her protest, appellant reported federal AGI of \$148,970, less California adjustments

⁴ We note that while appellant reported itemized deductions of \$8,070, as opposed to \$8,088, FTB's error is in appellant's favor and will not be addressed further.

⁵ This amount was calculated by taking appellant's California AGI of \$24,593 and subtracting prorated itemized deductions of \$1,669 (i.e., \$8,088 x 0.2064). The percentage of deductions allowed was calculated by dividing appellant's California AGI of \$24,593 by her AGI from all sources of \$119,133.

⁶ The percentage of credits allowed was calculated by dividing appellant's California taxable income of \$22,924 by her total taxable income of \$111,045.

⁷ This is the amount of tax due before applying the \$34 in taxes appellant remitted with her original Form 540.

(subtractions) of \$123,762, for an AGI from all sources of \$24,593. However, as explained above, all of appellant’s 2015 income must be reported on her California return, since income from all sources is used to calculate the tax rate that applies to her California sourced income. On the Form 540NR submitted by appellant, she incorrectly subtracted \$94,540⁸ from her federal AGI in calculating her AGI from all sources. The Form 540NR submitted by FTB, upon which the NOA is based, correctly calculated appellant’s AGI from all sources, and only appellant’s California-sourced income has been subjected to California tax.

Appellant has not provided any evidence to show error in either the proposed assessment or FTB’s application of the “California Method” to calculate appellant’s tax liability.

HOLDING

Appellant failed to demonstrate error in FTB’s use of the “California Method” to calculate appellant’s tax liability.

DISPOSITION

FTB’s action is sustained.

DocuSigned by:

Sheriene Anne Ridenour

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Sheriene Anne Ridenour
Administrative Law Judge

We concur:

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Huy "Mike" Le

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Huy “Mike” Le
Administrative Law Judge

DocuSigned by:

K. Long

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Keith T. Long
Administrative Law Judge

Date Issued: 6/30/2021

⁸ This amount consists of \$86,434 in wages and \$8,106 in pension and annuities. This amount is also the difference between the \$123,762 in California adjustments (subtractions), as reported on appellant’s Form 540NR, and the \$29,222 California adjustments (subtractions), as reflected on the Form 540NR FTB submitted (i.e., \$123,762 - \$29,222).