

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:
J. HAWKINS

) OTA Case No. 21129231
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OPINION

Representing the Parties:

For Appellant: Valerie C. McNevin, CMA, EA

For Respondent: Alisa L. Pinarbasi, Tax Counsel

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Hawkins (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$1,817 and applicable interest, for the 2016 taxable year.

Appellant elected to have this appeal determined pursuant to the procedures of the Small Case Program. Those procedures require the assignment of a single administrative law judge. (Cal. Code Regs., tit. 18, § 30209.1.) Appellant waived the right to an oral hearing; therefore, the Office of Tax Appeals (OTA) decides the matter based on the written record.

ISSUE

Has appellant established error in FTB’s proposed assessment of additional tax?

FACTUAL FINDINGS

1. Appellant moved to California on May 5, 2016. Appellant filed a timely California Nonresident or Part-Year Resident Income Tax Return for taxable year 2016. Appellant attached separate Forms W-2 showing wages earned while appellant resided in another state and wages earned while appellant resided in California. On the attached Schedule CA, appellant subtracted income of \$140,292 that appellant earned while he was a

- resident of another state. Appellant did not, therefore, use total income from all sources to calculate the tax rate applied to appellant's California wages of \$83,682.
2. FTB issued a Notice of Proposed Assessment (NPA) which calculated a tax rate of 8.13 percent which was applied only to appellant's California source income. Applying 8.13 percent to appellant's California taxable income of \$82,139, the NPA proposed total tax of \$6,678 before applying credits and subtracting the original tax paid by appellant.
 3. On the NPA, FTB prorated appellant's exemption credits based on the proportion of California taxable income to total income from all sources (37.36 percent). After applying the prorated exemption credits and an allowance for tax already reported by appellant on his original return, FTB proposed to assess additional tax of \$1,817, plus applicable interest.
 4. Appellant protested the NPA, and FTB issued a Notice of Action affirming the NPA.
 5. This timely appeal followed.

DISCUSSION

California residents are taxed on 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 (regardless of source) earned while residents of this state, as well as all income derived from California sources while nonresidents. (R&TC, § 17041(b) & (i).) It is well established that a presumption of correctness attends FTB's determinations of fact and that taxpayers have the burden of proving such determinations erroneous. (*Appeal of Head and Feliciano*, 2020-OTA-127P.)

Because appellant was undisputedly a part-year resident during the 2016 taxable year, he is subject to California tax on all income earned while a California resident from May 5, 2016, through December 31, 2016, and all income derived from California sources while a California nonresident from January 1, 2016, through May 4, 2016.

Here, OTA can readily distinguish between the two sets of wages since appellant's employer issued separate Forms W-2, only one of which includes wages for employment while appellant was a California resident totaling \$83,682. Therefore, it is clear that only that amount is taxable by California.

Appellant contends that FTB is taxing income earned while he resided in another state. FTB counters that it utilized appellant's total 2016 income but only for the purpose of calculating

the tax rate to apply to appellant's California taxable income, and to prorate deductions and credits applicable to appellant.

The calculation of the tax rate for a nonresident or part-year resident, as here, which is statutorily required by R&TC section 17041(b), is part of a multi-step process known as the "California method." The California method applies a formula to 1) prorate deductions between California and other jurisdictions, 2) calculate the tax rate applicable to a nonresident or part-year resident's California taxable income, and 3) prorate credits between California and other jurisdictions, as follows:

1. **Prorated Deductions.** To calculate the percentage of itemized deductions or the prorated standard deduction allowable, taxpayers must divide California adjusted gross income (AGI) by total 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 taxable income, taxpayers must divide the tax on the total taxable income (calculated as if the taxpayers were California residents for the entire year) by the taxpayers' total taxable income. The resulting rate is then applied to the taxpayers' California taxable income to determine the California tax. (R&TC, § 17041(b)(2).)
3. **Prorated Credits.** To calculate the percentage of credits allowed on the taxpayers' California returns, the California taxable income is divided by the total taxable income. The resulting ratio is then applied to the total exemption amount to find the prorated credits. (R&TC, § 17055.)

Step One

To calculate appellant's percentage of the 2016 California standard deduction¹ to apply to his California income, FTB divided appellant's California AGI (\$83,682) by total AGI from all sources (\$223,974), calculating a prorated standard deduction of \$1,543 (rounded). FTB then subtracted the \$1,543 from appellant's California AGI of \$83,862 to compute his California taxable income of \$82,139.

¹ The standard deduction for an individual for 2016 was \$4,129, which appellant claimed on his California tax return.

Step Two

To establish the tax rate to apply to appellant's California taxable income, FTB first determined that the tax on appellant's total taxable income would be \$17,869 if it were all taxable by California. FTB then divided that tax by appellant's total taxable income (\$219,845) to compute the California tax rate of 8.13 percent, to be applied only to appellant's California taxable income. The tax rate of 8.13 percent was applied only to appellant's California taxable income to compute California tax before exemption credits of \$6,678 (appellant's California taxable income of \$82,139 x .0813).

Step Three

After determining appellant's California tax before exemption credits, FTB calculated the percentage of exemption credits that appellant could apply, by dividing California taxable income (\$82,139) by total taxable income (\$219,845) to determine the portion of the exemption credits (\$111) to subtract from appellant's California tax. FTB allowed appellant 37.36 percent of the exemption credit, resulting in a prorated exemption of \$41 ($\111×37.36 percent, rounded). The California tax before exemption credits of \$6,678 less exemption credits of \$41, results in total California tax of \$6,637. This total California tax (\$6,637) minus the tax appellant originally reported on his return (\$4,820), results in the proposed additional tax of \$1,817 as calculated in the NPA. In short, FTB properly followed the steps using the California method to calculate appellant's revised California tax liability for 2016. (See R&TC, §§ 17041(b), 17304, 17055.)

Non-California Source Income Not Taxed by California

Appellant's position on appeal has not changed since appellant's protest with FTB. Appellant believes that using a higher tax rate is equivalent to taxing his income earned while he resided outside of California. OTA acknowledges that the California method used to compute a nonresident's or part-year resident's tax liability has caused no shortage of confusion for taxpayers. Nevertheless, a method similar to this essential part of the California method has been sustained by the courts. (See *Brady v. New York* (1992) 80 N.Y.2d 596 (*Brady*), cert. den. (1993) 509 U.S. 905 [evaluating a similar method of computing the tax rate for nonresidents under New York law].)

Use of the California method preserves the progressive nature of California’s tax system, such that taxpayers with similar incomes from all sources (and not just California) are taxed equally. In other words, the California method does not result in appellant’s out-of-state wages being subjected to California tax, but merely considers that income in computing the applicable tax rate. (*Appeal of Million* (87-SBE-036) 1987 WL 59534.) The *Brady* court noted the constitutionality of a similar method of establishing a tax rate on a nonresident, stating that “property not in itself taxable by the State may be used as a measure of the tax imposed.....It is in no just sense a tax upon the [out-of-state] property.” (*Brady*, supra, at p. 603, quoting *Maxwell v. Bugbee* (1919) 250 U.S. 525, 539.) Furthermore, the Tenth Circuit affirmed a decision by the U. S. District Court (D. Kansas) finding that a Kansas statute, that was similar to R&TC section 17041(b), did not violate the U. S. Constitution by either directly or indirectly taxing nonresident military income. (*U.S. v. State of Kansas* (1984) 580 F.Supp. 512, 515, affd. (10th Cir. 1987) 810 F.2d 935.) The Kansas statute merely considered the military pay of nonresident service members in determining the rate of income tax to be levied on the income earned in the state. (*Ibid.*)

The California method applies the same tax rate to similarly situated taxpayers. To illustrate:

Taxpayer A is a resident and Taxpayer B is a nonresident, both with a filing status of single who have \$100,000 of total taxable income, but Taxpayer B has only \$5,000 of California source income. For Taxpayer A, FTB starts with the tax on the \$100,000 of total income, which for 2021 was \$6,300.² Dividing \$6,300 by \$100,000, Taxpayer A’s tax rate on his or her \$100,000 of total income is 0.0630. This results in tax of \$315 on the first \$5,000 of Taxpayers A’s total \$100,000 of income ($\$5,000 \times 0.0630$). On the other hand, the tax rate on Taxpayer B’s \$5,000 of California source income would only be 1 percent, resulting in tax of \$50 ($\$5,000 \times 0.01$) if only Taxpayer B’s \$5,000 of California source income (rather than total taxable income) is used to determine the tax rate. Using total income to determine only the rate of taxation places Taxpayer B, a nonresident with \$100,000 of income, on equal footing with Taxpayer A, a California resident with \$100,000 of income, with both applying a tax rate of 0.0630 and paying \$315 of tax on \$5,000 of their \$100,000 total taxable income.

² California Tax Table for 2021 available at: <https://www.ftb.ca.gov/forms/2021/2021-540-taxtable.pdf>.

Here, FTB used appellant's out-of-state wage income only for the limited purpose of determining what tax rate to apply to appellant's California income and the amount of deductions and credits allowable on appellant's California return. Appellant's total taxable income of \$219,845, including the wages earned before appellant moved to California, was used to determine the tax that would be incurred had appellant been a California resident for the entire taxable year (\$17,869), resulting in a tax rate of 8.13 percent ($\$17,869 / \$219,845$). Applying the tax rate of 8.13 percent only to appellant's California taxable income results in California tax before exemption credits of \$6,678. Thus, FTB is not taxing appellant's out-of-state wages; rather, FTB simply followed the statutory California method to determine the rate to apply to appellant's California taxable income.


Based on the foregoing, appellant has not established error in FTB's proposed assessment.

HOLDINGS

Appellant has not established error in FTB's proposed assessment of additional tax.

DISPOSITION

FTB's action is sustained.

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Teresa A. Stanley
Administrative Law Judge

Date Issued: 6/28/2022