

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 21047552
A. WILLIAMS)
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OPINION

Representing the Parties:

For Appellant: A. Williams

For Respondent: Leoangelo C. Cristobal, Tax Counsel

For Office of Tax Appeals: Nguyen Dang, Tax Counsel III

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, A. Williams (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing \$891 of additional tax plus applicable interest, for the 2016 taxable year.¹

We decide the matter based on the written record because appellant waived the right to an oral hearing.

ISSUE

Has appellant shown error in FTB’s application of the California method of computing appellant’s tax?

FACTUAL FINDINGS

1. Appellant filed a 2016 California Nonresident or Part-Year Resident Income Tax Return, reporting \$82,070 of federal adjusted gross income (AGI) and \$75,581 of California AGI.

¹Appellant's request for appeal lists the amount at issue as \$1,064.71, which includes proposed additional tax of \$891.00 and interest of \$173.71 as of February 25, 2021. Appellant does not provide any specific arguments with respect to the interest and, as a result interest, will not be addressed further in this Opinion.

- Appellant computed tax before exemption credits of \$4,300 using a California tax rate of 5.99 percent. Appellant claimed prorated exemption credits totaling \$102 (92.09 percent of the exemption credit for an individual of \$111) and a prorated standard deduction of \$3,802 (92.09 percent of the standard deduction of \$4,129 for an individual in 2016).²
2. FTB later received information from the IRS indicating that appellant failed to report \$37,359 in pension income.
 3. FTB issued a Notice of Proposed Assessment (NPA) that included appellant's pension income and proposed to assess additional tax of \$3,406.
 4. Appellant protested the NPA and provided documentation showing that the additional pension income was not taxable by California, which FTB accepted.
 5. FTB issued a Notice of Action (NOA) conceding that appellant's pension income was excludable from appellant's California AGI but otherwise affirming the NPA. In the NOA, FTB calculated appellant's revised California tax before exemption credits of \$5,159 using total AGI of \$119,429,³ California AGI of \$75,581,⁴ and a California tax rate of 7.07 percent. The NOA allowed prorated exemption credits totaling \$70 (63.29 percent of the exemption credit of \$111) and prorated itemized deductions totaling \$2,613 (63.29 percent of the standard deduction of \$4,129). This resulted in a revised proposed assessment of additional tax of \$891.
 6. This timely appeal followed.

DISCUSSION

While California residents are taxed on their entire taxable income (regardless of source), nonresidents are only taxed on income from California sources. (R&TC, §§ 17041(a), (b), (i), 17951.) California law requires that nonresident taxpayers, such as appellant, compute the applicable California tax rate using the taxpayers' "entire taxable income." (R&TC, § 17041(b)(2).) It is only the tax rate that is computed using the entire taxable income of the

² The Form 540 instructions that contain the amounts of the standard deduction for 2016 are not in our record. Both parties reference \$4,129 and appear to agree that this was the amount of the standard deduction for an individual filing single for taxable year 2016.

³ The total AGI includes appellant's California source income of \$75,581, military pension income of \$37,359, and Alabama source income of \$6,489 ($\$75,581 + \$37,359 + \$6,489 = \$119,429$).

⁴ California AGI includes only appellant's California source income (\$75,581) as appellant reported on his original return.

nonresident as if the nonresident were a resident of this state. (*Ibid.*) This means that to compute the correct tax rate, appellant’s pension income must initially be considered, which appellant failed to do.

The calculation of the tax rate for a nonresident, 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 formulas to: (1) prorate deductions to determine the amount that may be deducted from appellant’s California income; (2) calculate the tax rate applicable to a nonresident or part-year resident’s California taxable income; and (3) prorate credits to determine the amount that may be applied against appellant’s California tax. These steps or computations can be summarized as follows:

1. **Prorated Deductions.** To calculate the percentage of itemized deductions or the prorated standard deduction allowable, the taxpayer must divide California 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, the taxpayer must divide the tax on the total taxable income (calculated as if the taxpayer was a California resident for the entire year) 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 the taxpayer’s California return, 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 – Prorated Deductions

To calculate appellant’s percentage of the 2016 California standard deduction to apply to his California source income, FTB divided appellant’s California AGI by total AGI from all sources, calculating a prorated standard deduction of \$2,613.⁵ FTB then subtracted the \$2,613 from appellant’s California AGI of \$75,581 to compute his California taxable income of \$72,968.

⁵ \$75,581 of California AGI (not including pension and Alabama source income) divided by \$119,429 total AGI (including pension and Alabama income) equals 0.6329, which is then multiplied by the 2016 standard deduction for an individual (\$4,129) to calculate the prorated standard deduction that appellant may deduct against his California source income (\$2,613).

Step Two – California Tax Rate and Resulting California Tax

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 \$8,146 if it were all sourced to California. FTB then divided that tax by appellant's total taxable income to compute the California tax rate of 7.07 percent.⁶ Next, the tax rate of 7.07 percent was applied only to appellant's California taxable income to compute California tax before exemption credits of \$5,159 (appellant's California taxable income of \$72,968 x 0.0707).

Step Three – Prorated Exemption Credits

After determining appellant's California tax before exemption credits, FTB calculated the percentage of exemption credits that appellant could apply, by dividing appellant's California taxable income by appellant's total taxable income to determine the portion of credits (\$70) to subtract from appellant's California tax.⁷ The California tax before exemption credits of \$5,159 less prorated exemption credits of \$70, results in total California tax of \$5,089. This total California tax (\$5,089) minus the tax appellant originally reported on his return (\$4,198), results in the proposed additional tax of \$891 as revised per the NOA. 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 pension income which is not taxable in California. OTA acknowledges that the California method used to compute a nonresident'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.

⁶ \$8,146 tax on total taxable income divided by \$115,300 total taxable income equals a 7.07 percent tax rate to be applied only to appellant's California source taxable income. Appellant's total taxable income of \$115,300 was calculated by subtracting the standard deduction for an individual of \$4,129 from appellant's total AGI of \$119,429.

⁷ \$72,968 of California taxable income divided by \$115,300 of total taxable income = 0.6329, which is multiplied by the exemption for an individual of \$111 to calculate the prorated exemption credit that appellant may apply to his California tax (\$70).

(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 pension income nor a portion of his wages from working in Alabama being subject 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, 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 the nonresident service member in determining the rate of income tax to be levied on the nonresident’s 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. Taxpayer B, the nonresident, has only \$5,000 of California source income. For Taxpayer A, the computation starts with the tax on the \$100,000 of total income, which for 2021 was \$6,300.⁸ 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 \$5,000 of Taxpayer’s A 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 Taxpayer B’s total taxable income is not 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 total income, on equal footing with Taxpayer A, a California resident with \$100,000 of total 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.

⁸ California Tax Table for 2021 available at: <https://www.ftb.ca.gov/forms/2021/2021-540-taxtable.pdf>.

Here, FTB used appellant's military pension and Alabama income only for the limited purpose of determining what tax rate to apply to appellant's California source income. Appellant's total taxable income of \$115,300,⁹ including the pension and Alabama source income, was used to determine the tax that would be incurred had appellant been a California resident for the entire taxable year (\$8,146), resulting in a tax rate of 7.07 percent ($\$8,146 / \$115,300$). Next, the tax rate of 7.07 percent was applied only to appellant's California taxable income to compute California tax before exemption credits of \$5,159.¹⁰ Thus, FTB is not taxing appellant's pension; rather, FTB simply followed the statutory California method to determine the rate to apply to appellant's California taxable income.

Appellant also asserts that he should be given "reciprocity" for military service. It is unclear what appellant means by this statement. However, OTA notes that the California method is modified when it is applied to certain individuals serving in the military who are not domiciled in this state. Where the servicemember is not domiciled in California, California may not include the servicemember's compensation for military service when calculating the applicable tax rate using the California method. (R&TC, § 17140.5(d)(1)(B).) However, the exception in R&TC section 17140.5(d)(1)(B) applies only to "compensation for military service" and does not apply to retired military servicemembers such as appellant. Additionally, income from sources within this state includes compensation for personal services performed within this state. (Cal. Code Regs., tit. 18, § 17951-5.) Therefore, appellant's compensation for non-military services performed within California is California source income which is taxable in California.¹¹

⁹ Appellant's total taxable income was calculated using total AGI of \$119,429 and subtracting the \$4,129 standard deduction for an individual filing single ($\$119,429 - \$4,129 = \$115,300$).

¹⁰ $\$75,581$ minus prorated deductions of \$2,613 equals \$72,968, which is then multiplied by 0.0707 to compute California tax of \$5,129.

¹¹ Appellant states that it is his understanding that he was not required to pay California state tax on his income including the income appellant earned while performing services in California during the 2016 taxable year. To the extent appellant is relying on R&TC section 17140.5(c)(2) which provides that "[c]ompensation for military service of a servicemember not domiciled in this state is not income for services performed or from sources within this state," OTA notes that appellant was not an active servicemember during the 2016 taxable year, and his compensation as a civilian employee of the Department of Defense is not compensation for military service. Thus, the exception contained in R&TC section 17140.5(c)(2) is not applicable, and appellant's compensation for services performed in California is California-source income pursuant to the general rule contained in California Code of Regulations, title 18, section 17951-5.

Based on the foregoing, appellant has not shown that FTB erred in its calculations of his income nor in the assessment of additional tax of \$891 for taxable year 2016.

HOLDING

Appellant has not shown error in FTB’s application of the California method of computing appellant’s tax.

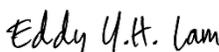
DISPOSITION

We sustain FTB’s action, as modified in the NOA issued to appellant.

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Teresa A. Stanley
Administrative Law Judge

We concur:

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Eddy Y.H. Lam
Administrative Law Judge

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Cheryl L. Akin
Administrative Law Judge

Date Issued: 11/22/2022