

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 230413080
W. FABRY)
)
)
)
)

OPINION

Representing the Parties:

For Appellant: W. Fabry
For Respondent: Kristin K. Yeager, Program Specialist

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045,¹ W. Fabry (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$962, and applicable interest, for the 2017 taxable year.

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 shown error in FTB’s proposed assessment of additional tax, which is based on a final federal determination?

FACTUAL FINDINGS

1. Appellant filed a timely California Non-Resident or Part-Year Resident Income Tax Return, using a married-filing-separately status for the 2017 taxable year. Appellant self-reported California wages of \$48,715, total tax of \$1,882, and an overpayment of

¹ On May 10, 2022, appellant paid FTB \$1,405.33, the total tax and interest stated in FTB’s March 11, 2022 Notice of Proposed Assessment (NPA). FTB has not yet applied that payment to appellant’s California tax liability for the 2017 taxable year. At the conclusion of this appeal, FTB may treat this matter as a claim for refund and calculate the amount of tax and interest, if any, to be refunded to appellant. OTA obtains its jurisdiction from the Notice of Action, which modified the NPA.

- \$2,625 after subtracting withholding credits. FTB accepted appellant's return as filed and refunded the requested amount to appellant.
2. Subsequently, FTB received information from the IRS that appellant had failed to report taxable dividends of \$4,627 and taxable pension/annuity distributions of \$8,870.
 3. FTB issued a Notice of Proposed Assessment (NPA), making corresponding changes, adding \$13,497 to appellant's total taxable income (\$4,627 + \$8,870). The NPA also treated both amounts as California income and included it in the computation of appellant's California taxable income. FTB also added back into appellant's income the \$1,140 in itemized deductions claimed by appellant on the 2017 return and allowed the larger, pro rata share of appellant's standard deduction.² The NPA proposed to assess \$1,195 in additional tax.
 4. Appellant timely protested the NPA. At protest, FTB determined that the taxable dividends were not from a California source or earned while appellant was a California resident.
 5. Appellant did not respond to FTB's letter dated October 31, 2022, and FTB issued a Notice of Action (NOA) which modified the NPA, excluding the \$4,627 of dividends from appellant's California taxable income, but not from appellant's total taxable income.
 6. Appellant timely appealed the NOA to OTA, stating that he moved to Alabama as of April 1, 2017, and claiming that only the wages he earned while residing in California should be included in his California taxable income.³
 7. On appeal, FTB prepared a pro forma tax return.⁴ On the pro forma return, FTB excludes both the dividend income of \$4,627 and the pension/annuity income of \$8,870 from appellant's California taxable income, but not from appellant's total taxable income. Applying the California Method to calculate appellant's California tax after excluding \$12,423 from appellant's California taxable income results in additional tax due of

² See calculation of appellant's prorated share of the California standard deduction (\$1,646), below.

³ Neither appellant's 1099s nor appellant's federal Wage and Income Transcript are in the appeal record. FTB conceded that the dividends were not paid by a California source or during the time appellant was a California resident and excluded it from appellant's California taxable income in the NOA. FTB, on appeal, concedes that the pension/annuity distributions should also be excluded from appellant's California taxable income. Because FTB's concessions favor appellant, OTA accepts FTB's categorization of the income.

⁴ Here, the pro forma tax return is a courtesy tax return prepared by FTB to show how appellant's 2017 taxes should have been calculated and reported.

\$1,291. FTB does not assert an increase from the \$962 additional tax proposed in the NOA.

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.) 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 nonresident. (R&TC, § 17041(b), (i).) California law requires that a part-year resident taxpayer, such as appellant, compute the applicable California tax rate, to apply to the taxpayer's California income, using the taxpayer's "entire taxable income." (R&TC, § 17041(b)(2).) It is only the tax rate and percentage of allowable credits and deductions that are computed using the entire taxable income of the part-year resident as if the part-year resident were a resident of this state for the entire year. (*Ibid.*) This means that to compute the correct tax rate, appellant's pension/annuity and dividend income must initially be included in appellant's total taxable income in order to calculate the *tax rate* that would have applied to appellant if all of his income were taxable in California.

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." (*Appeal of Williams*, 2023-OTA-041P). The California method applies formulas to: (1) prorate deductions to determine the amount to deduct from appellant's California taxable 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 to apply 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 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, 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.)

Appellant contends that the dividends he received are from a non-California source or earned while he resided in Alabama. Appellant also asserts that the pension/annuity distributions received were taken as a required minimum distribution (RMD)⁵ while appellant resided in Alabama. Appellant asserts that neither of those should be included in his California taxable income.

Based on the initial information received from the IRS, FTB contended that the unreported dividends and pension/annuity distributions should be included in appellant's total taxable income as well as in appellant's California taxable income. FTB later conceded that the dividends were not paid to appellant from any California source or while he resided in California. Therefore, in its NOA, FTB recalculated appellant's additional tax by excluding the dividends from appellant's California taxable income. On appeal, FTB concedes that neither the unreported dividends nor the unreported pension/annuity distributions should be included in appellant's California taxable income. However, FTB does use that unreported income to increase appellant's *total* taxable income.

Using the California Method, appellant's California tax is calculated as follows:⁶

⁵ RMDs are the minimum amounts a taxpayer must withdraw from a retirement plan account when the taxpayer reaches age 72 (73 if the taxpayer reaches age 72 after Dec. 31, 2022). (IRC, § 401(9).)

⁶ The appeal record includes three separate calculations by FTB, each using the California Method. In the NPA, FTB calculated additional tax of \$1,195 after including both the dividends and the pension/annuity income in appellant's California income. In the NOA, FTB calculated additional tax of \$962 after excluding the dividend income from appellant's California income but including the pension/annuity income. OTA analyzes the calculations in FTB's opening brief, which resulted in additional tax of \$1,291. FTB used an incorrect amount for appellant's total taxable income in both the NPA and the NOA. However, although correctly calculated on appeal, FTB conceded that it would not assert an increase from the \$962 additional tax calculated in the NOA.

Step One – Prorated Deductions

To calculate appellant's percentage of the 2017 California standard deduction to apply to his California income, FTB divided appellant's California AGI (\$48,715) by total AGI from all sources (\$125,352)⁷ to determine that appellant is entitled to 38.86 percent of the standard deduction of \$4,236, or \$1,646.⁸ FTB then subtracted \$1,646 from appellant's California AGI of \$48,715 to compute California taxable income of \$47,069.

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 \$8,620 if appellant had been a California resident for the entire taxable year.⁹ FTB then divided that tax by appellant's total taxable income from all sources (\$121,116)¹⁰ to compute a California tax rate of 7.12 percent.

Next, the tax rate of 7.12 percent was applied to appellant's California taxable income only to compute California tax before exemption credits of \$3,351 (appellant's California taxable income of \$47,069 \times 0.0712).

Step Three – Prorated Exemption Credits

After determining appellant's California tax before exemption credits, FTB calculated the percentage of exemption credits to apply by dividing appellant's California taxable income by appellant's total taxable income to determine appellant's prorated share of exemption credits of 38.86 percent ($\$47,069 \div \$121,116$). Applying 38.86 percent to total exemption credits results in prorated exemption credits of \$89 ($\228×0.3886). The California tax before exemption credits of \$3,351 less prorated exemption credits of \$89, results in total California tax of \$3,262. FTB

⁷ For purposes of calculating appellant's total AGI from all sources, California does not tax appellant's California tax refund of \$1,560 or appellant's social security income of \$26,863. Thus, those are excluded from appellant's federal AGI of \$153,775 to calculate appellant's AGI from all sources of \$125,352.

⁸ FTB used the prorated standard deduction because it exceeded the itemized deductions that appellant claimed. Appellant's claimed federal itemized deductions of \$8,121 included a \$6,981 state tax refund, which is not deductible in California. Thus, appellant's allowable share would have been less than the remaining \$1,140 after prorating the itemized deductions.

⁹ FTB used the 2017 540NR Tax Booklet to determine the amount of tax based on appellant's filing status of married filing separately.

¹⁰ Appellant's total AGI of \$125,352 minus the standard deduction (without proration) of \$4,236 equals \$121,116.

reduced the tax by the \$1,882 total tax originally reported by appellant on his return, plus the additional \$89 California tax withheld from appellant’s pension distribution, which was not reported by appellant on his return. This results in proposed additional tax of \$1,291 (\$3,262 - \$1,882 - \$89).


In short, FTB properly followed the steps using the California method to calculate appellant’s revised California tax liability for 2017. (See R&TC, §§ 17041(b), 17304, 17055.) Although the proper calculation results in additional tax of \$1,291, FTB does not assert that appellant owes more than the \$962 imposed in the NOA, plus applicable interest which accrued only until the date of appellant’s payment on May 10, 2022.


HOLDING

Appellant has not shown error in FTB’s proposed assessment of additional tax.

DISPOSITION

FTB’s action imposing additional tax of \$962, plus applicable interest, is sustained.

DocuSigned by:

0CC6C6ACCC8A44D...
Teresa A. Stanley
Administrative Law Judge

We concur:
DocuSigned by:

1A9B52EF88AC4C7...
Michael F. Geary
Administrative Law Judge

DocuSigned by:

F595B34010D8470...
Lauren Katagihara
Administrative Law Judge

Date Issued: 12/14/2023