

**OFFICE OF TAX APPEALS
STATE OF CALIFORNIA**

In the Matter of the Appeal of:)
J. GOLDSTEIN AND) OTA Case No. 220410145
A. GOLDSTEIN)
_____)

OPINION

Representing the Parties:

For Appellants: J. Goldstein
A. Goldstein

For Respondent: Lawrence Xiao, Attorney
Adam Susz, Attorney

E. LAM, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Goldstein and A. Goldstein (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing an additional tax of \$3,640 and applicable interest for the 2016 tax year.¹

Office of Tax Appeals (OTA) Administrative Law Judges Eddy Y.H. Lam, Sheriene Anne Ridenour, and Asaf Kletter held a virtual oral hearing for this matter on November 15, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an Opinion.

ISSUE

Whether appellants have shown error in FTB’s application of the California method of computing their tax.

¹ FTB determined that the amount of additional tax is \$3,640. However, FTB erroneously reduced the additional tax to \$2,482 in appellants’ favor on its January 10, 2022 position letter. Therefore, FTB is honoring the reduced amount in appellants’ favor and pursues only \$2,482 of additional tax.

FACTUAL FINDINGS

1. Appellants were residents of New York state and nonresidents of California during the 2016 tax year.
2. Appellants timely filed their joint 2016 California Nonresident or Part-Year Resident Income Tax Return (540NR).
3. On appellants' 540NR, they reported a total adjusted gross income (AGI) from all sources of \$237,262, after California adjustments. After claiming California itemized deductions totaling \$176,741, appellants reported a California total taxable income of \$60,521 (\$237,262 - \$176,741). On their Schedule CA (540NR), appellants reported a California AGI of \$211,208 and computed a deduction percentage of 89.02. Based on their calculations, appellants reported prorated itemized deductions of \$157,335 (\$176,741 in California itemized deductions x 0.8902), a California taxable income of \$53,873, and a California tax rate of 2.5 percent.
4. FTB received information from the IRS that it increased appellants' federal taxable income for the 2016 tax year to include unreported pension or annuities income and disallowed deductions. On October 12, 2020, FTB issued appellants a Notice of Proposed Assessment (NPA), which made conforming changes to appellants' California income and deductions. The NPA proposed to assess additional tax of \$3,688 and applicable interest.
5. Appellants timely protested the NPA. Appellants explained that they were not California residents and, aside from appellant J. Goldstein's partnership income, appellants had no other income sourced from or allocated to California; therefore, they disputed the additional tax and interest.
6. In a position letter dated January 10, 2022, FTB responded to appellants' protest explaining that nonresidents are taxed only on income from California sources through the California method, which does not tax appellants' non-California income; however, this method requires appellants to pay tax on their California source income at the same tax rate that would apply to a California resident with the same total income. For reasons unspecified in the letter, FTB stated it reduced appellants' tax to \$2,482 from \$3,688.
7. On March 8, 2022, FTB issued a Notice of Action (NOA) revising appellants' California total taxable income to \$131,136. Specifically, consistent with the federal changes, FTB

revised appellants' California AGI to reflect unreported pension or annuities income of \$61,005 and disallowed itemized deductions totaling \$9,610.² The NOA proposed to assess additional tax of \$3,640 and applicable interest.

8. This timely appeal followed.
9. On appeal, FTB and appellants stipulated that the maximum additional tax amount at issue in this appeal is \$2,482, honoring the reduced amount in appellants' favor from the January 10, 2022 position letter.
10. At the oral hearing, appellants clarified that they do not contest the federal changes.

DISCUSSION

R&TC section 18622(a) requires a taxpayer to concede the accuracy of federal changes to a taxpayer's income or state where the changes are erroneous. It is well settled that a deficiency assessment based on a federal adjustment to income is presumed to be correct and a taxpayer bears the burden of proving that FTB's determination is erroneous. (*Appeal of Valenti*, 2021-OTA-093P.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Ibid.*)

While California residents are taxed on their entire taxable income (regardless of source), nonresidents (like appellants, here) are only taxed on income from California sources. (R&TC, §§ 17041(a), (b), (i), 17951.) For a nonresident, the California tax rate is calculated using the taxpayer's "entire taxable income" as if the nonresident were a resident of California for the entire tax year. (R&TC, § 17041(b)(2).) Only the tax rate is computed using the entire taxable income of the nonresident as if the nonresident were a resident of this state. (*Ibid.*) When a federal determination results in changes to the taxpayer's entire taxable income due, the corresponding deficiency assessment computes the correct tax rate based on that entire taxable income. (See *Appeal of Williams*, 2023-OTA-041P [to determine the correct tax rate, unreported pension income must be considered].)

Calculating the tax for a nonresident taxpayer requires a multi-step process known as the California method. (R&TC, § 17041(b); *Appeal of Williams, supra.*) The California method applies formulas to: (1) prorate deductions to determine the amount deductible from the taxpayer's California income; (2) calculate the tax rate applicable to the taxpayer's California

² The disallowed itemized deductions include the following: \$4,650 for medical expenses; \$1,240 for miscellaneous deductions; and \$3,720 due to the recalculated itemized deduction limitation.

taxable income; and (3) prorate credits to determine the amount that may be applied against the taxpayer's California tax. (See R&TC, §§ 17304, 17041(b)(2), 17055; *Appeal of Williams, supra.*)

Here, appellants contend that no additional California tax should be due under the California method because none of the federal changes were associated with California-sourced income. Since appellants dispute the California method, OTA reviews FTB's application below.

Step One – Prorated Deductions

To calculate prorated itemized deductions, the taxpayer must divide "California AGI"³ (as defined in R&TC section 17301.3) by "total AGI"⁴ from all sources (as defined by R&TC section 17301.4), then apply the resulting ratio to the itemized deductions or standard deduction. (R&TC, § 17304.)

Here, appellants reported a California AGI of \$211,208, a total AGI from all sources of \$237,262, and a deduction percentage of 89.02 ($\$211,208 \div \$237,262$). However, based on a federal determination, FTB increased the total AGI from all sources to include appellants' unreported pension or annuities income of \$61,005. Based on a California AGI of \$211,208 and a revised total AGI from all sources of \$298,267 ($\$237,262 + \$61,005$), FTB calculated a revised deduction percentage of 70.81 ($\$211,208 \div \$298,267$). Before applying the percentage to appellants' deductions, FTB, consistent with the federal changes, decreased appellants' claimed California itemized deductions by \$9,610, from \$176,741 to \$167,131. FTB then applied the 70.81 percent ratio to appellants' California itemized deductions of \$167,131, resulting in prorated itemized deductions of \$118,345 ($0.7081 \times \$167,131$). OTA does not find any error in FTB's calculation of appellants' prorated deductions.

³ R&TC section 17301.3 provides that in the case of a nonresident or part-year resident, the term "California AGI" includes each of the following: (a) for each part of the taxable year during which the taxpayer was a resident of California (as defined by R&TC section 17014), all items of AGI, regardless of source; and (b) for any part of the taxable year during which the taxpayer was not a resident of California, AGI derived from sources within California, determined in accordance with Article 9 (commencing with R&TC section 17301) of Chapter 3 and Chapter 11 (commencing with R&TC section 17951).

⁴ R&TC section 17301.4 provides that in the case of a nonresident or part-year resident of California, the term "total AGI" means AGI for the entire year determined under R&TC section 17072 regardless of source, taking into account R&TC sections 17024.5 and 17203. For personal income tax purposes, California generally conforms to Internal Revenue Code section 62, defining federal AGI, except as otherwise provided. (R&TC, § 17072(a).) Therefore, taxpayers must generally report the same federal AGI from the federal tax return on their California tax return, subject to California-specific addition and subtraction modifications.

Step Two – California Tax Rate and Resulting California Tax

To establish the tax rate for California, the taxpayer must divide the tax on total taxable income (calculated as if the taxpayer were a California resident for the entire year) by the taxpayer's California total taxable income, then applying the resulting rate to the taxpayer's California taxable income. (R&TC, § 17041(b)(2); *Appeal of Williams, supra.*)

Here, to calculate the tax rate to apply to appellants' California taxable income, FTB first subtracted the prorated itemized deductions from appellants' total AGI from all sources. As mentioned above, based on federal changes, FTB reduced appellants' itemized deductions to \$167,131 and increased their total AGI from all sources to \$298,267. Here, FTB determined a total taxable income of \$131,136 ($\$298,267 - \$167,131$), resulting in a tax of \$7,043 as if all of appellants' total taxable income was entirely subject to California tax. FTB then divided the tax of \$7,043 by appellants' total taxable income of \$131,136 to compute a California tax rate of 5.37 percent ($\$7,043 \div \$131,136$). FTB calculated appellants' California taxable income as \$92,863 (\$211,208 of California AGI - \$118,345 of prorated itemized deductions). FTB then multiplied the 5.37 percent tax rate by appellants' California taxable income of \$92,863, to determine appellants' California tax (before exemption credits) of \$4,987 ($\$92,863 \times 0.0537$). OTA does not find any error in FTB's calculation of appellants' California tax rate and the resulting tax.

Step Three – Prorated Exemption Credits

To calculate the percentage of exemption credits allowed on the taxpayer's California return, the taxpayer must divide the California taxable income by the total California taxable income, and then apply the resulting ratio to the total exemption credit amount. (R&TC, § 17055; *Appeal of Williams, supra.*) Here, FTB divided California taxable income of \$92,863 by total taxable income of \$131,136 to obtain the prorated exemption credit of 70.81 percent ($\$92,863 \div \$131,136$). OTA finds no error in FTB's computation of the prorated exemption ratio and the determination that appellants cannot claim any exemption credits due to the AGI limitations for the 2016 tax year.

In short, OTA finds that FTB properly followed the steps using the California method to calculate appellants' additional California tax liability. (See R&TC, §§ 17304, 17041(b), 17055.)

Non-California Source Income Not Taxed by California

During the oral hearing, appellants asserted that there is “no California sourced income” because all of appellant J. Goldstein’s income is in the form of guaranteed payments as a non-equity partner of two separate law firms earned during distinct periods of employment in New York.

However, appellants’ assertion that they do not have any California-sourced income is unconvincing. Here, the tax return originally filed by appellants indicates on Schedule CA (540 NR), Part II, Section A – Income, line 17, column E, that appellants received \$211,208 in California-sourced income. During the oral hearing, appellants contended that the \$211,208 California-sourced income is from a Schedule K-1 calculated by appellant J. Goldstein’s law firm that potentially has businesses in California.⁵ However, appellants offered no additional clarification or presented any evidence to dispute the California-sourced nature of the reported amount. OTA finds that the evidence in the record does not suggest that the \$211,208 in income is not California-sourced income.

Appellants argue that by recalculating the tax rate under the California method, FTB taxes their non-California sourced pension or annuities income. Appellants support their contention by referencing the sourcing rules for California sourced income under R&TC sections 17952, 17952.5, and 17955(a). Appellants also assert that *Clackamas Gastroenterology Assocs., P. C. v. Wells* (2003) 538 U.S. 440, together with *Brady v. New York* (1992) 80 N.Y.2d 596 (*Brady*), cert. den. (1993) 509 U.S. 905, indicates that there is no nexus between appellants and California justifying a tax on any of the appellants’ income earned in New York.⁶ Therefore, appellants take the position that California has no basis to tax any of their income, let alone the authority to impose additional assessments of tax.

To reiterate, nonresidents are taxed on income derived from California sources. (R&TC, §§ 17041(a), (b), (i), 17951.) As indicated in the second step of the California method, it is evident that FTB did not subject appellants’ unreported annuities or pension income of \$61,005

⁵ Appellants did not clarify which specific law firm issued a K-1 reflecting California sourced income.

⁶ OTA notes that appellants also assert that: (i) appellants have never been residents of California; (ii) A. Goldstein was a Form W-2 taxpayer; (iii) J. Goldstein is non-equity partner who received K-1’s in such capacity; (iv) appellants have no additional income from his employment aside from their retirement funds; and (v) appellants have no other contacts with the state of California. However, OTA has considered these arguments made by appellants and finds them to be irrelevant and without merit.

to California tax. Appellants' total AGI from all sources, including the \$61,005 of unreported pension or annuities, is used for the sole purpose of computing the tax rate that applies to appellants' California-sourced income of \$211,208. In other words, the California method does not result in appellants' pension or annuities income being subject to California tax, but merely takes into account that income in computing the applicable tax rate. (*Appeal of Williams, supra.*) The 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 income) are taxed equally.⁷ (*Ibid.*)

Conclusion

FTB properly followed all three steps using the California method to calculate appellants' revised California tax liability. (See R&TC, §§ 17041(b), 17304, 17055.) Here, appellants offered no additional clarification or presented any evidence to dispute the California-sourced nature of the reported amount of \$211,208. The California method also does not result in California taxing appellants' total AGI from all sources, including the \$61,005 of unreported pension or annuities. Based on the foregoing, appellants have not established that FTB erred in its calculations of their income nor in the assessment of additional tax.

⁷ 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*, 80 N.Y.2d at p. 603, quoting *Maxwell v. Bugbee* (1919) 250 U.S. 525, 539.)

HOLDING

Appellants have not shown error in FTB’s application of the California method of computing their tax.

DISPOSITION

FTB’s action is modified to reduce the proposed additional tax assessment to \$2,482 as stipulated by both parties. FTB’s action is otherwise sustained.

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Eddy Y.H. Lam
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Eddy Y.H. Lam
Administrative Law Judge

We concur:

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Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

DocuSigned by:
Asaf Kletter
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Asaf Kletter
Administrative Law Judge

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