OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **B. CRITCHFIELD AND** **M. CRITCHFIELD**	OTA Case No. 230112490

OPINION

Representing the Parties:

For Appellants: B. Critchfield
M. Critchfield

For Respondent: Josh Ricafort, Attorney

E. LAM, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, B. Critchfield (appellant-husband) and M. Critchfield (appellant-wife) (collectively, appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $2,437 and applicable interest for the 2017 tax year.

Appellants waived the right to an oral hearing; therefore, the Office of Tax Appeals (OTA) decides this matter based on the written record.

ISSUE

Whether appellants have shown error in FTB's application of the California method to compute their tax.

FACTUAL FINDINGS

1. Appellants timely filed their joint 2017 California Resident Income Tax Return (Form 540). Appellants reported on the Form 540 a federal adjusted gross income (AGI) from all sources of $297,781; a California wage subtraction adjustment of $96,244; and a California taxable refunds subtraction adjustment of $1,811, resulting in a California AGI of $199,726. After claiming California itemized deductions totaling $13,544, appellants reported a California taxable income of $186,182 ($199,726 California AGI - $13,544

California itemized deductions). Following the deduction of exemption credits totaling $934, appellants reported a tax of $11,094.

2. FTB issued to appellants a Notice of Proposed Assessment (NPA), indicating that FTB disallowed appellants' wage subtraction of $96,244, resulting in additional tax of $8,951.
3. Appellants timely protested the NPA. Appellants asserted that appellant-wife is not a California resident and the California wage subtraction of $96,244 represents appellant-wife's wages earned in Nevada.
4. FTB responded and issued a California Income Tax Examination letter dated June 9, 2022 (First Examination Letter). In the First Examination Letter, FTB informed appellants that, among other things, FTB's NPA will be revised to recompute tax liability using the nonresident or part-year resident method of taxation, equivalent to filing a California Nonresident or Part-Year Resident Income Tax Return (Form 540NR).
5. By letter dated July 7, 2022, appellants responded that appellant-wife resided in Nevada while earning her wages during the entire 2017 tax year and attached additional supporting documents.
6. In response, FTB issued a California Income Tax Examination letter dated September 26, 2022 (Second Examination Letter). In the Second Examination Letter, FTB determined that appellant-wife was a nonresident for the 2017 tax year and that the entirety of her earned wage income of $96,244 was not sourced to California.
7. Consequently, FTB issued a Notice of Action (NOA) and revised the proposed additional tax to be $2,437 and applicable interest. In relevant parts, the NOA determined that appellants' 2017 California tax rate is 7.43 percent, which FTB derived by dividing the tax of $20,979 on total taxable income by appellants' California total taxable income of $282,426. Thereafter, based on FTB's agreement with appellants' contention that appellant-wife's income is not subject to California tax, FTB applied the resulting California tax rate of 7.43 percent to appellants' California taxable income of $190,587, which solely comprises of appellant-husband's California AGI in the amount of $199,726, less the prorated itemized deductions of $9,139. As a result, the California Tax Before Exemption Credits is calculated as $14,161 ($190,587 x 0.0743). Thereafter, FTB applied the resulting exemption credits ratio of 67.48 percent to obtain the

exemption credits amount of $630, resulting in a total California tax of $13,531 ($14,161 - $630).

8. This timely appeal followed.

DISCUSSION

FTB's determination is presumed to be correct, and a taxpayer has the burden of proving error. (*Appeal of Stabile*, 2020-OTA-198P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of Mazer*, 2020-OTA-263P.)

It is undisputed by FTB and appellants that appellant-wife was a nonresident of California and that the entirety of her earned wage income of $96,244 is not sourced to California for the 2017 tax year.[1] Here, FTB revised its proposed assessment and computed it based on the California method, which does not tax appellants' non-California income, but 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. Accordingly, OTA assesses whether FTB's revised computation appropriately employs the California method for appellants.

The California Method of Taxing Nonresidents

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 Williams*, 2023-OTA-041P.) This method does not tax out-of-state income received while a taxpayer is a nonresident of California, but merely takes into account a

[1] The determination of whether an item of income is taxable in California to the nonearning spouse (here, appellant-husband) can be broken down into a two-step analysis. (*Appeals of Cremel and Koeppel*, 2021-OTA-222P.) The first step requires a determination of the nonearning spouse's marital property interest in the earning spouse's income. (*Ibid*.) Here, it is undisputed that both California and Nevada are community property states. (Fam. Code, § 760; Nevada Revised Statutes, § 123.220.) Accordingly, appellant-husband (nonearning spouse) has a one-half marital property interest in appellant-wife's (earning spouse's) earned income. As to the second step, it requires a determination of whether the nonearning spouse's interest in such income is taxable in California either because the nonearning spouse is a resident of California who is taxed on all income regardless of source, or because the nonearning spouse is a nonresident, but the income is California source income. (*Appeals of Cremel and Koeppel*, *supra*.) Here, FTB does not contend that appellant-husband's one-half marital property interest in appellant-wife's wages contributes to his taxable income. In fact, FTB concedes that the entirety of appellant-wife's income of $96,244 is not sourced to California for the 2017 tax year according to the Second Examination Letter. As FTB's concession is advantageous to appellants, OTA affirms FTB's concession and will not discuss or analyze the allocation of community property any further in this appeal.

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 taxpayers' California taxable income. The purpose of the California method is to apply the graduated tax rates to all individuals, not just those who reside in California.

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 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, OTA has reviewed the NOA and finds no error to the resulting additional tax due.

Step One – Prorated Deductions

To calculate prorated itemized deductions, the taxpayer must divide "California AGI" [2] (as defined in R&TC section 17301.3) by "total AGI" [3] 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, FTB ultimately calculated appellants' total AGI from all sources to be $295,970, which FTB computed by taking appellants' originally reported federal AGI of $297,781, less California taxable refunds subtraction adjustment of $1,811. (See R&TC, § 17301.4.) FTB also determined that appellants' California AGI is $199,726, which is the same California AGI as originally reported by appellants. The California AGI includes the income of appellant-husband and excludes appellant-wife's earned income in Nevada. Based on a California AGI of $199,726 and a revised total AGI from all sources of $295,970, FTB calculated a deduction percentage of

[2] 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 any 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).

[3] 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.

67.48 ($199,726 ÷ $295,970). FTB then applied the 67.48 percent ratio to appellants' originally reported California itemized deductions of $13,544, resulting in prorated itemized deductions of $9,139 (0.6748 × $13,544). OTA does not find any error in FTB's calculation of appellants' prorated deductions.

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 apply the resulting rate to the taxpayer's California taxable income. (R&TC, § 17041(b)(2); *Appeal of Williams, supra*.)

Here, FTB determined appellants' total taxable income to be $282,426 ($295,970 total AGI from all sources - $13,544 claiming California itemized deductions), which would have resulted in a tax of $20,979 if all of appellants' total taxable income was entirely subject to California tax. FTB then divided the tax of $20,979 by appellants' total taxable income of $282,426 to compute a California tax rate of 7.43 percent ($20,979 ÷ $282,426). From step one of the California method, FTB calculated appellants' California taxable income to be $190,587 ($199,726 of California AGI - $9,139 of prorated itemized deductions). FTB then multiplied appellants' California taxable income of $190,587 by the 7.43 percent tax rate to determine appellants' California tax before exemption credits of $14,161 ($190,587 × 0.0743). 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 a taxpayer's California return, the taxpayer must divide the California taxable income by the total 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 $190,587 by total taxable income of $282,426 to obtain the prorated exemption credit of 67.48 percent ($190,587 ÷ $282,426). Appellants' claimed federal exemption amount of $943 multiplied by the 67.48 prorated exemption percent ratio results in $630. OTA finds no error in FTB's computation of the prorated exemption ratio and the resulting calculation of appellants' California tax of $13,531 ($14,161 - $630), as reflected in the NOA. Here, after deducting the original tax of $11,094,

which appellants remitted with their original 2017 California resident income tax return, the revised additional tax due is properly determined to be $2,437 ($13,531 - $11,094).

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)(2), 17055.)

On appeal, appellants argue that no additional tax liability and applicable interest should be due because appellant-wife earned her income in Nevada and is domiciled in Nevada. However, California has a progressive tax system. (*Appeal of Williams, supra*.) Therefore, it is permissible for California to employ appellants' non-California income in the revised computation of their 2017 California tax rate to compute their total California tax liability.[4] As indicated in the second step of the California method, appellants' total taxable income of $282,426 is used for the sole purpose of computing the tax rate that applies to appellants' California taxable income. In other words, the California method does not subject appellant-wife's income of $96,244 to California tax, but merely takes that income into account when 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. (*Ibid*.) Here, appellants have not shown any error in FTB's calculation of appellants' tax liability, which OTA finds consistent with the applicable law. In fact, appellants have not provided—and OTA is not aware of—any authority or support for an alternative tax calculation. Accordingly, appellants have not carried their burden of proving error.

[4] The fundamental fairness and the constitutionality of using out-of-state income to calculate the rate of tax has been upheld by New York's highest court, and the United States Supreme Court refused to hear an appeal from the New York decision. (See *Brady v. New York* (1992) 80 N.Y.2d 596, cert. den. (1993) 509 U.S. 905.)

HOLDING

Appellants have not shown error in FTB's application of the California method to compute their tax.

DISPOSITION

FTB's action is sustained.

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

We concur:

DocuSigned by:
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Andrew Wong
Administrative Law Judge

DocuSigned by:
Lauren Katagihara
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Lauren Katagihara
Administrative Law Judge

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