OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **S. ISSA**	OTA Case No. 230513173

OPINION

Representing the Parties:

For Appellant: S. Issa

For Respondent: Josh Ricafort, Attorney

For Office of Tax Appeals: Tom Hudson, Attorney

E. LAM, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, S. Issa (appellant) appeals from the action of respondent Franchise Tax Board (FTB) proposing to assess additional tax of $1,416, plus applicable interest for the 2017 tax year. Appellant waived the right to an oral hearing; therefore, the Office of Tax Appeals (OTA) decides this matter based on the written record.

ISSUE

Whether appellant has shown error in the proposed assessment.

FACTUAL FINDINGS

1. Appellant filed a timely California Resident Income Tax Return for 2017 (original return), electing the married filing separately status. Appellant reported a federal adjusted gross income (AGI) of $294,982.[1] Appellant also reported a total of $45,721 in California subtraction adjustments, in Schedule CA (540), which consisted of the

[1] Appellant's federal AGI included $113,748 of wages from Defense Finance and ACTG Serv; $110 of taxable refunds; $21,910 of taxable amount of pension and annuities; $21,808 of taxable social security benefits; and $137,406 of gambling winnings. Appellant's Form W-2 reports wages of $113,747 instead of $113,748. The nominal difference does not change the outcome of this appeal.

following: $110 in taxable refunds, $22,203 in pension and annuities,[2] $21,808 in social security benefits, and $1,600 of gambling winnings. This resulted in a California AGI of $249,261. After claiming California itemized deductions[3] totaling $138,544, appellant reported a California taxable income of $110,717, a tax liability of $7,653, total payments of $5,429, and a tax due of $2,224.

2. FTB issued a Notice of Proposed Assessment (NPA) stating that the California subtraction adjustments for pension income and gambling losses were disallowed and proposed additional tax, along with applicable interest.
3. Appellant timely protested the NPA. Appellant argued, among other things, that appellant was a non-resident of California. In support, appellant provided additional information and documentation.
4. FTB determined that appellant was a non-resident of California.
5. On April 5, 2023, FTB issued a Notice of Action (NOA) and converted appellant's tax return to a California Nonresident Income Tax Return. This resulted in a revised proposed additional tax assessment calculated using a multistep process required by R&TC section 17041(b), which is known as the California method.[4]
6. In relevant part, the NOA increased appellant's taxable income by $23,803, calculated a California tax rate of 7.33 percent, calculated a credit and deduction rate of 91.97 percent, and proposed additional tax of $1,416, plus interest.
7. This timely appeal followed.

DISCUSSION

FTB's determinations are generally presumed correct, and the taxpayer bears the burden of proving otherwise. (*Appeal of Vardell*, 2020-OTA-190P, Cal. Code Regs., tit. 18, § 30219(c).) Unsupported assertions cannot satisfy a taxpayer's burden of proof. (*Appeal of Johnson*, 2022-OTA-166P.) In the absence of credible, competent, and relevant evidence

[2] The total amount of pension and annuities was $22,203, but only $21,910 was included in appellant's federal AGI. As such, appellant subtracted an additional $293 ($22,203 - 21,910 = $293) in pension and annuities income from California income.

[3] As relevant to this appeal, appellant deducted gambling losses of $137,406 as an itemized deduction on the federal return.

[4] See *Appeal of Williams*, 2023-OTA-041P.

showing that FTB's determination is incorrect, it must be upheld. (*Appeal of Chen and Chi*, 2020-OTA-021P.)

It is undisputed by the parties that appellant was a nonresident of California and that the entirety of appellant's pension income is not sourced to California. Here, FTB revised its NPA and computed appellant's proposed assessment based on the California method. Accordingly, OTA assesses whether FTB's revised computation appropriately employs the California method to determine appellant's tax.

The California Method of Taxing Nonresidents

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 taxpayer's "entire taxable income." (R&TC, § 17041(b)(2).) It is only the tax rate that is computed using the entire taxable income of the nonresident as if the nonresident were a resident of this state. (*Ibid*.) This method does not tax out-of-state income received while a taxpayer is a nonresident of California, but merely takes into account a 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 taxpayer's California taxable income.

The calculation of the tax rate for a nonresident, which is statutorily required by R&TC section 17041(b), is part of 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 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*.) OTA examines each of the applied formulas in turn.

Step One – Prorated Deductions

To calculate prorated itemized deductions, the taxpayer must divide "California AGI" [5] (as defined in R&TC section 17301.3) by "total AGI" [6] 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; *Appeal of Williams*, *supra*.)

Here, FTB determined appellant's total AGI from all sources to be $273,064. This is determined by taking appellant's originally reported federal AGI of $294,982 and modifying it based on the following California subtraction adjustments: $110 in California taxable refunds; and $21,808 in social security benefits.[7] (See R&TC, § 17301.4). Appellant's California AGI is $251,153,[8] which consists of the following: $113,747 in wages earned in California from Defense Finance and ACTG Serv; and $137,406 in gambling winnings won in California.[9] Based on a California AGI of $251,153 and a revised total AGI from all sources of $273,064, appellant's deduction percentage is 91.97 ($251,153 ÷ $273,064). After applying the 91.97 percent ratio to appellant's originally reported itemized deductions of $138,544, appellant's

[5] 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).

[6] 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.

[7] The California taxable refunds were properly subtracted from appellant's federal AGI because California excludes state income tax refunds from taxable income. (R&TC §17220.) Similarly, the social security benefits were properly subtracted because social security benefits are generally not taxable for California tax purposes. (R&TC, § 17087(a).)

[8] FTB used gambling winnings of $137,407 instead of $137,406 shown on appellant's federal return and calculated California AGI of $251,154. The $1 nominal difference and does not affect appellant's additional tax. But for purposes of this appeal, OTA determines that the California AGI is $251,153, in favor of appellant.

[9] Appellant's gambling winnings as reported on the forms W-2G show total winnings of $138,603; however, FTB accepted appellant's reported winnings of $137,406, which favors appellant. Appellant does not dispute, and evidence in the record indicates that the claimed gambling winnings were California-sourced income because Forms W-2G reflect that the gambling income was won in California. (Cal. Code Regs., tit. 18, § 18662-5(a)(2)(K).)

prorated itemized deductions total $127,419 (0.9197 × $138,544). Although there are minor calculation errors made by FTB, the errors favor appellant, who has shown no additional errors were to appellant's detriment.

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 appellant's total taxable income to be $134,520 ($273,064 total AGI from all sources - $138,544 claimed itemized deductions), which would have resulted in a tax of $9,867 if all of appellant's total taxable income was entirely subject to California tax using appellant's filing status of married filing separately. FTB then divided the tax of $9,867 by appellant's total taxable income of $134,520 to compute a California tax rate of 7.33 percent ($9,867 ÷ $134,520). Appellant's California taxable income totaled $123,720 ($251,153 of California AGI - $127,433 of prorated itemized deductions). After multiplying appellant's California taxable income of $123,720 by the 7.33 percent tax rate appellant's California tax before exemption credits totaled $9,069 ($123,720 × 0.0733). Appellant has not identified any specific error in the calculation and OTA does not find any material error in FTB's calculation of appellant's 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 $123,721 by total taxable income of $134,520 to obtain the prorated exemption credit of 91.97 percent ($123,721 ÷ $134,520). Here, appellant did not claim any federal exemption; therefore, there is nothing for FTB to prorate. OTA finds no error in FTB's computation of the prorated exemption ratio and the resulting calculation of appellant's California tax of $9,069, as reflected in the NOA. Here, after deducting the original tax of $7,653, which appellant remitted with the original return, the

revised additional tax due is properly determined to be $1,416 ($9,069 - $7,653). In short, OTA finds that FTB properly followed the steps using the California method to calculate appellant's additional California tax liability. (See R&TC, §§ 17304, 17041(b)(2), 17055.)

Appellant's position on appeal is that there are no additional taxes owed. Appellant supports this contention by providing a copy of the NOA, with the income adjustment amount of $23,803 crossed out. The disputed income adjustment amount of $23,803 is derived from FTB's disallowance of the following California subtraction adjustments made by appellant: $22,203 in claimed pension and annuities income and the $1,600 in gambling winnings.

Appellant contends that the $22,203 in claimed pension and annuities income was properly reported and subtracted on the original tax return and that FTB's disallowance of the subtraction is not warranted. It appears that appellant contends that since the pension and annuities income was earned outside of California, it should not result in a revised total taxable income of $134,520. However, California has a progressive tax system. (*Appeal of Williams, supra*.) As indicated in the second step of the California method, appellant's total taxable income of $134,520 is used for the sole purpose of computing the tax rate that applies to appellant's California taxable income. In other words, the California method does not subject the pension and annuities income 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*.) OTA finds no error in FTB's calculation with regard to disallowing the $22,203 in claimed pension and annuities subtraction adjustment.[10]

Appellant's final argument pertains to the $1,600 in gambling winnings subtracted on the California tax return, asserting that it is not a duplicate deduction because the federal itemized deduction was limited by federal AGI for the 2017 tax year. (See Internal Revenue Code, § 68.) Here, appellant reported $137,406 in gambling winnings as part of federal AGI and deducted the same amount in losses as a federal itemized deduction. Appellant contends entitlement to an additional $1,600 in gambling losses for California purposes because the federal AGI limitation

[10] The total amount of pension and annuities was $22,203, but only $21,910 was taxable as included in the federal AGI. However, appellant subtracted the entire $22,203 in pension and annuities income. There was no need to subtract the nontaxable portion of appellant's pension income ($293) as a California subtraction adjustment because it was not included in appellant's federal or California AGI. Nonetheless, appellant's claimed California subtraction of the entire $22,203 in pension and annuities income was disallowed.

for the 2017 tax year reduced appellant's the itemized deduction for California purposes. However, a California subtraction adjustment, as provided in Schedule CA (540), is generally used to report adjustments to gross income when that income is taxed differently for California and federal purposes.[11] Here, appellant has not identified any specific error in the disallowed deduction, and OTA is unaware of any statutory authority or support that would allow appellant to deduct more itemized deductions than what has already been permitted for California tax purposes. Furthermore, OTA finds FTB's calculation of appellant's tax liability to be consistent with the applicable law. Accordingly, appellant has not carried the burden of proving error.

HOLDING

Appellant has not shown error in the proposed assessment.

DISPOSITION

FTB's proposed assessment is 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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Teresa A. Stanley
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Teresa A. Stanley
Administrative Law Judge

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

Date Issued: 9/18/2024

[11] (See California Form 540-NR, 2017 Instructions for Schedule CA, https://www.ftb.ca.gov/forms/2017/17-540nrca-instructions.html .)