Interstate Commerce Initiative

NTUF NATIONAL TAXPAYERS UNION FOUNDATION

Issue Brief

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BY ANDREW WILFORD

California Court Upholds Confusing and Punitive Tax Assessment on Nonresidents

If California's New Year's resolution was to avoid unnecessarily confusing and burdensome tax assessments on out-of-state taxpayers, it has already failed. This time, the state's Office of Tax Appeals (OTA) has upheld an assessment by the state's Franchise Tax Board (FTB) counting tax-exempt sources of income towards the determination of a taxpayer's tax marginal tax rate.

The California Method

Andrew Williams, an Alabama resident with substantial income in California, filed a 2016 Nonresident/Part-Year Resident Tax Return based on $82,070 in federal Adjusted Gross Income (AGI) and $75,581 in California AGI. Williams did not report $37,359 in military pension income, as this income was not taxable by California (and Alabama does not require him to report it on his state tax return). The California FTB accepted that the pension income was not taxable, but nevertheless claimed that it meant that Williams owed $891 in additional California income tax.

How? California requires nonresident taxpayers to calculate their tax rate as if all their income were sourced to California, then multiply that tax rate by their California-sourced income. This is in contrast to many other states, which simply prorate the value

Key Facts:

California's Office of Tax Appeals recently ruled against a nonresident who objected to the "California method" of artificially boosting out-of-state taxpayers into higher tax brackets.

This "California method" requires that even though a source of income is tax-exempt in the state it is sourced to, out-of-state taxpayers must include it for the purpose of calculating their California tax rate on California-sourced income.

Not only does this method effectively undermine other states' tax policies, it is also confusing and counterintuitive to out-of-state taxpayers snared by it.

of deductions and credits based on the percentage of income sourced to the state. In other words, a taxpayer who earns just 10 percent of his total income in a given state would receive just 10 percent of the value of that state's standard deduction.

California's strange approach to calculating nonresidents' and part-year residents' tax burdens means that even income that California has no power to tax affects a taxpayer's California income tax assessment.

That's because additional income, even income that is not taxable in the state it is sourced to (in this case, Alabama), is taxed in progressively higher brackets in California. The pension income and Alabama-sourced income that is not sourced to California (and not taxed by California) nevertheless bumped up the California tax rate that Williams pays from 5.75 percent to 7.07 percent.

On appeal, California's OTA sided with the FTB. The OTA essentially held that California's method of taxing out-of-state taxpayers was necessary to ensure that out-of-staters felt the full bite of California's progressive tax code: "Use of the California method preserves the progressive nature of California's tax system...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."

It's not the first time that OTA has come to this conclusion — in 2020, the OTA ruled the same way on an FTB assessment using a part-year resident's Texas-sourced income (not taxable in Texas) to count towards determining the taxpayer's California income tax rate. In both cases, taxpayers were expected to know that tax-exempt income nevertheless increased their *California* income tax liability.

Neither is California the only state to do things this way. New York and Kansas each had similar rules go to court. While they have survived legal challenges, they are nonetheless confusing and likely to cause issues for unwary taxpayers.

A Confusing Way to Tax

In general, states do not do a good job of recognizing that taxpayers are unlikely to be experts in their home state's tax code, let alone the tax codes of states around the country. This becomes an added issue for nonresident taxpayers, for whom each quirk in a state's tax code is doubly burdensome.

In this case, Williams did what most taxpayers would do — followed his home state's rules on what income needed to be reported. After all, why would California need to know about income that wasn't even sourced to it?

While courts have consistently held that including nontaxable income in tax calculations is legal so long as the income itself is not directly taxed, California's method does undermine Alabama's intended policy towards military pensions. At the end of the day, Williams owed nearly $900 more in California tax because of Alabama-sourced income that Alabama intended to be tax-exempt.

What's more, it's just the latest in a series of actions by California that signal disregard to how its aggressive tax policies affect out-of-state taxpayers. From a "doing business" tax on passive investors definitionally *not* "doing business" in California, to using a prior agreement with Amazon to assess retroactive tax obligations on sellers using Amazon's "Fulfilled By Amazon" services, to considering the use of virtual chats and software updates to constitute business income tax nexus, California is cultivating quite an unfortunate reputation as a state that will latch on to any argument necessary, no matter how specious, to maximize its tax revenue.

Conclusion

While the prorated exemptions method of taxing nonresidents is more straightforward, states must be careful not to override other states' policies regarding their income that falls under their jurisdiction.

Consequently, states preferring California's method of taxing nonresidents should strive to match exemptions for taxpayers' income sourced to other states when considering a taxpayer's marginal tax rate.

More broadly speaking, as taxpayers become more mobile and earning income in multiple states becomes a more common phenomenon, states must begin to adjust to reflect that. As the economy changes, avoidable additional burdens on out-of-state taxpayers only become more costly.

About the Author

Andrew Wilford is the Director of the Interstate Commerce Initiative at National Taxpayers Union Foundation.

2023 National Taxpayers Union Foundation
122 C Street NW, Suite 700, Washington, DC 20001
ntuf@ntu.org