2024 California Personal Income Tax

This course discusses tax law from the Franchise Tax Board's *Personal Income Tax Booklet*, Form 540 for the State of California. This basic tax course is designed for existing tax preparers who currently hold a valid CTEC ID with the California Tax Education Council (CTEC). Upon completion of this course, the student will receive 5 State Hours of continuing education credits in reference to the California Tax Education Council (CTEC).

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Introduction

As a tax professional, you know that staying up to date with the latest changes in tax law is essential. This course provides five credit hours of California tax law coverage as required annually for Certified Registered Tax Preparers (CRTPs), and the materials are also useful to California CPAs. The course will direct your attention to provisions and requirements included in the Tax Preparation Act, as codified in the California Business and Professions Code (California Code) §§ 22250 through 22259.

This course covers the latest developments in federal and California tax law, emphasizing areas of non-conformity. There are important rule differences related to contributions to and withdrawals from retirement accounts, and changes made by the SECURE Act 2.0 related to required minimum distributions, just to name two areas. We will delve into worker classification issues—employee vs. independent contractor—and the implications this has for taxation.

We'll start with an overview of the different types of taxes in California and the various taxing authorities, then examine how to determine residency for tax purposes. Next, we'll review the different filing statuses available to taxpayers. We'll also cover California and federal income and how they work together when preparing taxes in California. You will have ample examples of how to source different types of income for California income tax purposes.

Course Objectives

After successfully completing this course, you will be able to identify, recall, and recognize the correct treatment of rules and procedures for the following:

- recent federal tax law changes and areas of California conformity and partial conformity
- the broad scheme of taxation in California, including income tax, property tax, and sales and use tax, to name a few
- residency status and filing status
- the relationship between the federal tax return and the California tax return, specifically with respect to the manner in which federal adjusted gross income provides the starting point for completing the California tax return
- different types of income and California sourcing issues
- the various withholding requirements (payroll tax, tax on certain real estate) California law places on transfers of funds to taxpayers
- requirements for estimated tax payments, annual tax payments, and taxpayer and tax preparer penalties

Chapter 1. California and Federal Updates

Introduction

In this chapter, you will learn about California tax law changes made by the state legislature up to and including its 2022–2023 session, federal and state coronavirus-related stimulus legislation, and areas of conformity and non-conformity between California and federal tax rules.

California fully or partially conforms to several changes made to **federal law by the 2023 Consolidated Appropriations Act**. This section of the course covers key provisions in **California Public Law 117**. There is also a brief review of important changes made in 2021 and 2022.

Topics have been chosen based on their relevance in the 2023 and 2024 California filing seasons.

Chapter Objectives

After successfully completing this chapter, you will be able to:

- recall recent federal tax law changes and areas of California conformity and partial conformity
- recognize proper procedures for powers of attorney, accessing MyFTB as a CRTP, and related issues

Distributions from Retirement Plans

Required Minimum Distributions (RMDs)

Age Requirement

CAA §107 notes that California conforms to IRC §401 and §408's increases in the age for required minimum distributions to age 73 for individuals who attain age 72 after December 31, 2022, and before January 1, 2033. It also increases the age for RMDs to age 75 for individuals who attain age 74 after December 31, 2032. **California conforms.**

Penalties

CAA §302 reduces the excise tax for failure to take the RMD from 50 percent to 25 percent and further reduces it to 10 percent if the RMD is corrected in a timely manner. **California conforms.**

Pre-Death Distributions

CAA §325 removes the pre-death required minimum distribution from a Roth plan that is part of an employer-provided retirement plan. **California conforms.**

Early Withdrawals

Emergency Withdrawals

CAA §115 provides an exception to the early withdrawal penalty on qualified retirement plans for certain emergency personal expenses. The distribution is limited to one per calendar year and is capped at thelesser of $1,000 or the excess of the individual's nonforfeitable accrued benefit over $1,000. The distribution may be repaid under the applicable distribution repayment rules. The law goes into effect on December 29, 2022, and applies to distributions made after December 31, 2023. **California conforms.**

Terminal Illness

CAA §326 provides an exemption from the 10 percent additional tax on early distributions for a distribution from a retirement account in the case of an individual with a terminal illness. **California conforms.**

First Responder Payments

CAA §308 adds private sector firefighters to the exception from the tax on early distributions if they separate from service during or after a year the plan participant reaches age 50 or 25 years of service under the plan, whichever is earlier. CAA §309 allows for the exclusion of certain disability-related first responder retirement payments from gross income, which will apply to amounts received in taxable years beginning after December 31, 2026. California, however, does not conform to this federal change, and payments will be taxable under California law. **California conforms.**

Domestic Abuse Related Withdrawals

CAA §314 provides for a penalty-free withdrawal from retirement plans for individuals in cases of domestic abuse, limited to the lesser of $10,000 or 50 percent of the present value of the nonforfeitable accrued benefit of the employee under the plan. The contribution amount may be re-contributed to a retirement

plan and treated as a rollover distribution, similar to qualified birth or adoption distributions. **California conforms.**

Public Safety Employees

CAA §329 modifies the eligible age for exemption from the early withdrawal penalty. Under prior federal law, the additional tax did not apply to distributions from qualified plans for employees that separate from service at age 55 and age 50 for qualified public safety employees from a government plan. The federal provision expands the exception to the additional tax on early distributions to qualified public safety employees in government plans and private sector firefighters that separate from service after age 50 or after they have 25 years of service under the plan, whichever is earlier.

The provision expands the definition of qualified public safety employees to include corrections officers and forensic security employees who provide for the care, custody, and control of forensic patients. The provision applies to distributions made after December 29, 2022.

California conforms to the federal changes made to IRC §72(t) regarding the additional tax on early distributions from qualified plans. The expanded definition of qualified public safety employees in government plans would apply for California purposes, and employee distributions would not be subject to a California early withdrawal tax if they are not subject to the federal additional tax on early distributions. **California conforms.**

Disasters – Partial Conformity

CAA §331 provides special rules for using retirement funds in connection with qualified federally declared disasters.

Federal law allows tax-favored withdrawals from retirement plans up to $22,000 for qualified disaster distributions in connection with a federally declared disaster. The distribution is taxed ratably over a three-year period and may be re-contributed within three years, with payments receiving direct rollover treatment. Federal law also allows individuals who received qualified distributions to recontribute those qualified distributions into an eligible retirement plan for a qualified first-time homebuyer distribution, which was used to purchase or construct a principal residence in a qualified disaster area.

The federal provision also enables qualified individuals to receive **retirement plan loans** in amounts up to the lesser of $100,000 or the present value of the nonforfeitable accrued benefit of the employee under the plan. Repayment on these loans may be suspended for a period of up to one year if repayment of the loan normally would be due during the period beginning on the first day of the disaster incident period and ending 180 days from the last day of the incident period.

California conforms to IRC §72(t)'s additional tax on early distributions from qualified plans as applicable for federal purposes. The qualified disaster distribution would not be subject to a California early withdrawal tax if they are not subject to the federal tax on early distributions. The re-contribution of withdrawals for home purchases automatically applies under California law. **However, the amendments to IRC §72(p) for loans from qualified plans would not apply for California purposes.**

Corrections Employees

CAA §330 provides an exemption from the early withdrawal penalty for certain state and local government corrections employees. The exemption applies to distributions made after December 29, 2022, and California conforms to this section. **California conforms.**

Qualified Tuition Plans (529 Plans) – California Does Not Conform

IRC §529 allows qualified tuition plans that have been maintained for 15 years to be distributed to a Roth IRA without tax or penalty. The effective date is December 29, 2022, and it applies to distributions after December 31, 2023. California does not conform to this change—**such distributions from a §529 plan to a Roth IRA are includable in California taxable income and subject to a 2.5 percent premature distribution penalty.** Distribution from an IRA to Certain Charitable Trusts

IRC §529 allows qualified tuition plans that have been maintained for 15 years to be distributed to a Roth IRA without tax or penalty. The effective date is December 29, 2022, and it applies to distributions after December 31, 2023. California does not conform to this change—**such distributions from a §529 plan to a Roth IRA are includable in California taxable income and subject to a 2.5 percent premature distribution penalty. California conforms.**

Knowledge Check

Test Your Knowledge!

Which of the following statements is true regarding California's conformity with federal requirements?

California does not conform to the increase in IRA catch-up contribution limits.

This answer is incorrect. California conforms.

California conforms to the changes allowing penalty-free withdrawals for domestic abuse victims.

Correct. California conforms to the changes allowing penalty-free withdrawals for domestic abuse victims.

California does not conform to the increase in age for required minimum distributions.

This answer is incorrect. California conforms.

California only partially conforms to the special disaster-related distribution rules.

This answer is incorrect. California fully conforms to the rules related to non-taxability of disaster-related distributions.

The SECURE Act

Federal law allows an income tax credit for 50 percent of the first $1,000 in administrative and retirement education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan. The federal deduction is reduced by the amount of the credit. California has no similar credit.

Contributions to Retirement Plans

Catch-Up Limits for Qualified Defined Contribution Plans

CAA §109 increases the catch-up limit for qualified defined contribution plans for individuals who are between the ages of 60 and 63. The limit is increased to the greater of $10,000 or 150 percent more than the regular applicable dollar amount in 2024. For SIMPLE IRA plans, the catch-up limit is increased to the greater of $5,000 or 150 percent more than the regular applicable dollar amount in 2025. The law goes into effect on December 29, 2022, but applies to taxable years beginning after December 31, 2024.

CAA §603 requires that catch-up contributions for participants with wages of more than $145,000 are subject to mandatory Roth tax treatment, effective for taxable years beginning after December 31, 2023. **California conforms.**

Nonelective Contributions to SIMPLE Retirement Plans: California Conforms

CAA §116 allows employers to make nonelective contributions to a SIMPLE retirement plan up to 10 percent but not more than $5,000 to an employee who has made at least $5,000 in compensation in the year. The law goes into effect on December 29, 2022, and applies to taxable years after December 31, 2023.

The law increases the contribution amount, including catch-up contributions, by 10 percent for SIMPLE plans for an employer with less than 25 employees. It also allows large employers with more than 25 employees who received at least $5,000 in compensation in the preceding year to provide a matching 4 percent or 3 percent employer contribution. The law goes into effect on December 29, 2022, and applies to taxable years after December 31, 2023. **California conforms.**

Small Employers – Partial Conformity

CAA §117 increases the contribution limit for SIMPLE plans by 10 percent for employers with less than 25 employees and allows large employers with over 25 employees and at least $5,000 in compensation in the preceding year to provide a matching 4 percent or 3 percent employer contribution. This change will be effective for taxable years after December 31, 2023.

California automatically conforms to the federal changes made to IRC §408, **but the amount of elective deferrals that can be excluded is limited to the amount excludable under the IRC provisions in effect on January 1, 2010, as per RTC §17501(c).**

Student Loan Payments

Employers may treat qualified student loan payments as elective deferrals or contributions to qualified retirement plans, such as 401(k), 403(b), 408 (IRA), and 457 plans, for their employees who are making qualified student loan payments. A qualified student loan payment is defined as a payment made by an employee in repayment of a qualified education loan to pay for higher education expenses. The law goes into effect on December 29, 2022, but applies to contributions made for plan years beginning after December 31, 2023.

Knowledge Check

Test Your Knowledge!

What is a qualified student loan payment?

a payment made by an employer in repayment of a qualified education loan to pay for higher education expenses

This answer is incorrect. A qualified student loan payment is a payment made by an employee, not an employer.

a payment made by an employee in repayment of a qualified education loan to pay for higher education expenses

Correct. A qualified student loan payment is a payment made by an employee in repayment of a qualified education loan to pay for higher education expenses.

a payment made by an employer in repayment of a non-qualified education loan to pay for higher education expenses

This answer is incorrect. A qualified student loan payment is a payment made by an employee in repayment of a qualified education loan, not a non-qualified education loan.

a payment made by an employee in repayment of a non-qualified education loan to pay for higher education expenses

This answer is incorrect. A qualified student loan payment is a payment made by an employee in repayment of a qualified education loan, not a non-qualified education loan.

Saver’s Credit

Federal law replaced the Saver’s Credit with the Saver’s Match, where individuals who contribute to a retirement savings plan would receive a federal match of 50 percent of the employee’s contributions, up

to $2,000 per individual (applicable to taxable years beginning after December 31, 2026). California does not conform (§103). **California does not conform.**

ABLE Accounts

Federal law modified the age requirement for designated benefits of Achieving a Better Life Experience accounts so that eligible individuals have to be blind or disabled before attaching age 46 (instead of 26). This provision is effective for federal tax purposes for taxable years beginning after December 31, 2025.

California's age limitation remains 26. California does not conform to the federal age change (§124). California ABLE Program

For taxable years beginning on or after January 1, 2016, the California Qualified ABLE Program was established, and California law generally conforms to the federal income tax treatment of ABLE accounts. This program was established to help blind or disabled U.S. residents save money in a tax-favored ABLE account to maintain health, independence, and quality of life. Additional information can be found in the instructions of form FTB 3805P, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

Section 529 Plans

Federal law allows qualified tuition plans (§529 plans) that have been maintained for 15 years to be distributed to a Roth IRA without tax or a penalty. The transfer must be trustee to trustee, cannot exceed the aggregate amount contributed and earnings to the 529 plan more than five years before the distribution, and is limited to an aggregate of $35,000 in the current and prior taxable years. An amount distributed from a 529 plan to a Roth IRA is treated in the same manner as the earnings and contributions of a Roth IRA. This change applies to distributions made after December 31, 2023.

California does not conform to this change. Any distribution from a 529 plan to a Roth IRA would be includable in California taxable income and subject to a **2.5 percent premature distribution penalty** (§126). **California does not conform.**

First Responders

For taxable years beginning after December 31, 2026, federal law excludes from gross income certain disability-related retirement payments received by first responders (law enforcement officers, firefighters, paramedics, or emergency medical technicians) after reaching retirement age.

California does not conform to the federal changes related to the gross income exclusion for disability retirement payments for first responders—these payments would be **taxable in California** (§309). **California does not conform.**

Advanced Manufacturing Investment Credit

Federal law provides a non-refundable advanced manufacturing investment credit in an amount equal to 25 percent of the qualified investment to any advanced manufacturing facility of an eligible taxpayer. An advanced manufacturing facility is defined as a facility that manufactures semiconductors or semiconductor manufacturing equipment. Qualified property means tangible personal property for which depreciation is allowable and that is integral to the operation of the advanced manufacturing facility. An eligible taxpayer may elect to treat the credit as a payment against tax for the taxable year. The credit is only allowed on the construction of property that begins before December 31, 2026. **California does not conform to this credit** (§107).

Renewable Electricity Production Credit

The Inflation Reduction Act of 2022 extended the renewable electricity production credit and modified the definition of geothermal or solar energy facilities. The base credit amount is modified from 1.5 cents to 0.3 cents. The credit can be increased for certain qualified facilities, including those with a maximum net output of less than 1 megawatt or that use certain materials produced within the United States. The phase-out provision applies to taxpayers who make an elective payment in lieu of the credit.

Federal law also extended the energy credit to facilities that began construction before January 1, 2025, or January 1, 2035, if the property uses the ground or groundwater as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure. The base energy percentage amount is modified from 30 percent to 6 percent for certain property types, and from 10 percent to 2 percent for other energy property not included in the list. The credit amount is increased for energy projects that meet the prevailing wage requirements and apprenticeship requirements. The provision applies a phase-out for certain property types that begin construction after December 31, 2019, and are placed in service before January 1, 2022. **California does not conform to the renewable electricity production credit** (§169).

Worker Status: Employees and Independent Contractors

Some individuals may be classified as independent contractors for federal purposes and employees for California purposes, which may also cause changes in how their income and deductions are classified.

California Law – ABC Test

As of January 1, 2020, California workers must be considered employees rather than independent contractors unless proven otherwise. That is, this default classification rule requires that companies hiring independent contractors must classify them as employees unless an exception applies. This gig worker legislation codifies a test referred to as the "ABC test," which is designed to make it easier for businesses and workers to determine in advance whether a worker is an independent contractor or an employee.

A hiring entity must be sure to make payroll deductions to withhold taxes and Social Security. Calling a worker an "independent contractor" and issuing an IRS Form 1099 instead of a W-2 does not control employment status. Instead, the ABC test is used.

The ABC test originated in the 2018 state supreme court case Dynamex v. Superior Court of Los Angeles.[1] This case is explained on the California Labor and Workforce Development Agency's (California LWDA's) Web page.[2] As set forth in the Dynamex case, the ABC test requires that a hiring entity must satisfy three conditions in order for a worker to be treated as an independent contractor instead of an employee:

- The worker is free from the control and direction of the hiring entity in the performance of the work.
- The worker performs tasks that are outside the usual course of the hiring entity's business.
- The worker is customarily engaged in an independently established trade, occupation, or business that is of the same nature as the work performed for the hiring entity.

Unless all three prongs are satisfied, the worker is an employee and therefore protected by certain labor and employment laws, including the labor code and the unemployment insurance code, as well as any wage orders issued by the Industrial Welfare Commission. More specifically, the test determines a worker's eligibility for certain protections and benefits, including the following:

- unemployment insurance
- disability insurance, including workers' compensation insurance
- paid family leave
- wage and hour laws—minimum wage, overtime, meal periods, rest breaks
- workplace safety laws
- anti-retaliation laws
- access to state agencies (such as the Labor Commissioner's Office) to seek enforcement of employment and labor laws (e.g., instead of being limited) to civil suits for breach of contract

Employers are required to register with California's Employment Development Department (EDD) as an employing unit and remit payroll taxes beginning January 1, 2020. An employer that underpays its

employees' share of payroll taxes risks being subject to interest and penalties. There are civil penalties of $5,000 to $25,000 per violation, applicable to willful misclassification of individuals as independent contractors. Additionally, employers risk being required to pay their employees' share of payroll taxes.

It should also be noted that State Bill 459 (implemented in 2011) makes certain paid advisors jointly and severally liable for giving bad advice. That is, a non-attorney, paid preparer (i.e., a "person who, for money or other valuable consideration") who knowingly advises an employer to treat an individual as an independent contractor in order to avoid employee status, and that individual is later determined not to be an independent contractor, can be held jointly and severally liable with the employer.

California Non-Conformity

Federal laws such as the Fair Labor Standards Act apply different tests to determine employee status. Workers may, in many instances, be considered employees under California law even though they are considered independent contractors under federal law.

Exempt Occupations

California law makes certain occupations and business relationships exempt from the ABC presumption that a worker is an employee. Such occupations include lawyers, accountants, doctors, and realtors, to name a few. There are also exceptions for photographers, editors, freelance writers, and others who make 35 or fewer submissions a year.

Note that some taxpayers may be classified as independent contractors for federal purposes and as employees for California purposes. In such instances, there will be adjustments required on the California return.

Other Recent California Developments

Motion Picture Credit

There is a California tax credit of up to 20 percent of qualified expenditures paid or incurred by a qualified motion picture produced at a certified studio construction project in the state. The carryover period is nine years.

CalEITC and Dependent Exemption Credit

California has recently:

- loosened the requirement to use Social Security numbers, allowing limited use of federal ITINs by eligible individuals
- expanded eligibility for the Young Child Tax Credit (YCTC) by loosening identification requirements

- expanded eligibility for the dependent exemption credit by allowing taxpayers with nonresident alien dependents who are not eligible to receive a federal ITIN to use other identifying information

Loans Forgiven Under the Paycheck Protection Program

California law matches federal law, and forgiven PPP loans are excluded from California gross income.

Turf Replacement Water Conservation Program

For taxable years beginning on or after January 1, 2022, and before January 1, 2027, California law allows an exclusion from gross income for any amount received as a rebate, voucher, or other financial incentive issued by a public water system, as defined, local government, or state agency for participation in a turf replacement water conservation program.

Fire Victims Trust Exclusion

For taxable years beginning before January 1, 2028, California law allows a qualified taxpayer an exclusion from gross income for any amount received from the Fire Victims Trust, established pursuant to the order of the United States Bankruptcy Court for the Northern District of California dated June 20, 2020, case number 19-30088, docket number 8053. If a qualified taxpayer included income for an amount received from the Fire Victims Trust in a prior taxable year, the taxpayer can file an amended tax return for that year. If the normal statute of limitations has expired, the taxpayer must file a claim by September 29, 2023.

Thomas and Woolsey Wildfires Exclusion

For taxable years beginning before January 1, 2027, California law allows a qualified taxpayer an exclusion from gross income for any amount received in a settlement from Southern California Edison for claims relating to the 2017 Thomas Fire or the 2018 Woolsey Fire. If a qualified taxpayer included income for an amount received from these settlements in a prior taxable year, the taxpayer can file an amended tax return for that year. If the normal statute of limitations has expired, the taxpayer must file a claim by September 29, 2023.

R&TC §41 Reporting Requirements

Taxpayers should file form FTB 4197, Information on Tax Expenditure Items, with the FTB to report **tax expenditure items** as part of the FTB's annual reporting requirements. "Tax expenditure" means a credit, deduction, exclusion, exemption, or any other tax benefit provided for by the state. The FTB uses information from form FTB 4197 for reports required by the California Legislature. Taxpayers that have a reporting requirement for any of the following should file form FTB 4197:

- for taxable years beginning before January 1, 2027, qualified taxpayers who benefited from the exclusion from gross income for any amount received in a settlement from Southern California Edison for claims relating to the 2017 Thomas Fire or the 2018 Woolsey Fire
- for taxable years beginning on January 1, 2022, and before January 1, 2027, taxpayers who benefited from the exclusion of gross income for any amount received as a rebate, voucher, or other financial incentive issued by a public water system, as defined, local government, or state agency for participation in a turf replacement water conservation program
- for taxable years beginning on or after January 1, 2021, taxpayers who benefited from the exclusion from gross income for the Paycheck Protection Program loans forgiveness, other loan forgiveness, the Economic Injury Disaster Loan advance grant, restaurant revitalization grant, or shuttered venue operator grant, and related eligible expense deductions
- beginning in taxable year 2020, a taxpayer operating a commercial cannabis activity that is licensed under California Medicinal and Adult-Use Cannabis Regulation and Safety Act

AB 85 and SB 113

AB 85 limited the use of business tax credits to $5 million annually for tax years 2020 to 2022; SB 113 changed this limitation so that it would not apply to 2022.

For personal income tax filers and corporate taxpayers, the total of all business credits (including any carryover of business credits) for the taxable year can't reduce the net tax (for personal income tax filers) or tax (for corporate taxpayers) by more than $5 million.

Combined Report Taxpayers

For taxpayers included in a combined report (e.g., groups of businesses filing together), this limitation is applied at the group level.

Credit Carryover

If any credits are disallowed due to this $5 million limitation, they can be carried over to the following years. The carryover period for these disallowed credits is extended by the number of taxable years the credit wasn't allowed.

Low-Income Housing Credit Exception

The $5 million limit does not apply to the Low-Income Housing Credit, which remains unaffected by these changes.

Information for Certified Registered Tax Preparers (CRTPs) and Other Representatives

The Franchise Tax Board allows and prefers for communication to be transmitted through the online MyFTB portal rather than by mail.

Access to MyFTB

Individuals who plan to use the MyFTB online system must first register at the FTB website according to their respective roles. Those users who wish to gain access to more than one section (e.g., both individual and business sections) must register separately for each section and thus create separate accounts with a unique username for each role.

The following specific pieces of information are required in order for tax preparer registration to be accepted:

- a valid e-mail address
- Social Security number or federal Employer Identification Number (EIN)
- the following identification numbers:
  - Preparer Tax Identification Number (PTIN)
  - California CPA license number
  - California state bar number
  - Enrolled Agent (EA) license number with a California address

Note that the FTB no longer accepts the electronic filer identification number (EFIN) or the California Tax Education Council number for purposes of identification on MyFTB.

After completing the online registration process, users will receive a PIN by mail within three to five days at the address the FTB has on file for the user. After receiving the PIN, the user must log in to MyFTB within 21 days and enter the PIN to activate his or her account.

Power of Attorney

California tax professionals can secure permission from their clients to see tax information and communicate directly with the FTB on behalf of clients by executing a legal document called a power of attorney (POA). More specifically, a standard POA declaration can be used to give the tax pro or other representative the legal right to use MyFTB to accomplish the following:

- Receive and review a client’s confidential account information.
- Discuss the account and otherwise represent a taxpayer in FTB matters.
- Obtain copies of information the FTB receives from the IRS.
- Remove another representative from the taxpayer’s account.
- Revoke the POA.

A taxpayer may also select additional power(s) to grant to a representative, including:

- adding representatives
- signing tax returns if the taxpayer is incapacitated or continuously absent from the United States
- receiving but not endorsing refund checks
- waiving the California statute of limitations (SOL)
- executing settlement or closing agreements

Note

POAs filed before January 1, 2018, give the representative the right to waive the California statute of limitations and execute settlement or closing agreements as standard (rather than optional) elections on the POA form.

Power of Attorney Declarations

The FTB launched the FTB 3912-Power of Attorney-Active Representations on File letter, which provides a list of all active POA representative relationships on the taxpayer's account. Intended to keep taxpayers informed of their POA relationships, this letter was sent to all taxpayers with an active POA on file with the FTB.

A POA declaration generally requires the filing of FTB Form 3520-PIT, Individual or Fiduciary Power of Attorney Declaration. This form replaces FTB Form 3520. The FTB no longer accepts Form 3520. Certain IRS forms can be used instead of Form 3520-PIT. The www.FTB.com has information related to such alternative forms of POA assignment. A POA declaration is generally valid for six years unless revoked or otherwise canceled.

A portion of this form is shown below.

STATE OF CALIFORNIA
Franchise Tax Board

Individual or Fiduciary Power of Attorney Declaration

CALIFORNIA FORM
3520-PIT

Use this legal document to authorize a specific individual(s) to receive confidential information and represent you in all matters before the Franchise Tax Board (FTB).

Part I – Taxpayer Information

Check only one box below.

☐ **Individual** (If a joint tax return is filed, each spouse/Registered Domestic Partner (RDP) must complete their own POA Declaration)

☐ **Fiduciary** (Estate or Trust – **FEIN required**)

Individual (first name, middle initial, last name, suffix) or name of estate or trust | SSN or ITIN

Street address (number and street) or PO box | Apt. no/ste. no. | FEIN

City (If you have a foreign address, see instructions) | State | ZIP code | Phone

Foreign country name | Foreign province/state/county | Foreign postal code

Part II – Representative(s)

Only individuals may be named as representatives. You must list a primary representative below. The individual or fiduciary in Part I appoints the following individual(s) as attorney(s)-in-fact. To appoint additional representatives, complete Side 4. Each representative listed on your power of attorney (POA) Declaration will have the ability to remove a representative from your POA Declaration.

Primary representative's name (first name, middle initial, and last name)

CA CPA | CA state bar number | CTEC | Enrolled agent number | PTIN

Street address (number and street) or PO box | Apt. no/ste. no.

If a taxpayer wishes to provide a respresentative with only the ability to retrieve tax information, the taxpayer should file FTB Form 3534, Tax Information Authorization (TIA). A TIA is valid for 13 months unless revoked or otherwise canceled.

Submitting POA Declarations

Although a POA declaration can be submitted either by a client or tax professional, the procedure is different in each case and also depends on whether the declaration is submitted online or on paper. Since 2016, the FTB has preferred online submissions over paper submissions, but the taxpayer or tax pro can find instructions for paper POA declarations on the FTB's website or by contacting the FTB. Paper submissions should generally only be used for such circumstances as the following:

- The taxpayer or tax pro is unable to access MyFTB (due to being on active duty in a combat zone, being located in a disaster area, etc.).
- The taxpayer has a documented physical or mental impairment.
- The tax pro is an out-of-state attorney without a PTIN, EFIN, or California CPA license number.
- The assigned representative is a relative, friend, or other person without a professional designation.

Client Submits Declaration

The simplest method is when the client submits the declaration online. In these cases, the FTB reviews the declaration and processes the request after validating the information provided about the client and intended representative(s).

Tax Pro Submits Declaration

In most cases, it is likely that a POA declaration request would be submitted online by the tax practitioner. However, the subsequent approval of the client is needed before the FTB will process the request. This approval can either take place online or in written form.

Client Approval

After the FTB has received the POA request and validated the information it contains, the client must sign in to his or her MyFTB account to approve (or reject) the request. If the client approves the request, the FTB will process the POA declaration and inform the client accordingly by letter.

FTB Approval Process and Timeline

The FTB reviews the information in the POA declaration and rejects forms that are incomplete, incorrect, or contradictory. The tax pro should be mindful that common reasons for rejection are:

- There are mismatches between information filed in an online POA request and the associated uploaded Form FTB 3520-PIT.
- There are signature(s) missing from FTB 3520-PIT or an equivalent form.
- The tax years specified in the paper POA are missing or incorrect.

Filing online helps the taxpayer or tax pro avoid delays due to rejection by immediately identifying errors. Additionally, online filing generally results in a turnaround time of 30 days or less rather than the 45 to 90 business days required for mail-in declarations.

Once a POA has been approved, the FTB puts a ten-day hold on account access as a security measure. Taxpayers and representatives should keep this delay in mind when planning their application timeline and associated tax matters.

Revoking or Extending a POA

A POA is valid for six years unless it is revoked or the representative is removed. The tax pro or taxpayer should continue to check current POAs on file with the FTB to ensure current awareness about representatives who still have rights to waive the SOL and to execute settlement and closing agreements even if the taxpayer did not specifically select those rights. Revocation is most quickly accomplished by using MyFTB to file Form 3520-RVK - Power of Attorney Declaration Revocation. If the taxpayer does not have online access, he or she should contact the FTB as soon as possible in order to revoke a representative's power.

To extend a POA, a new Form 3520-PIT form must be filed with the FTB.

Anyone on the POA declaration—the individual taxpayer, the business taxpayer, or the representative named on the declaration—can end the POA at any time.

Example

CRTP Hans is named as the primary representative on POA declarations for three different clients from 2020, 2021, and 2022, respectively. Since POA declarations remain active for six years unless they are revoked, all three cases are still active. Hans wants to make sure that he receives e-mail copies of all notices sent to his clients, but he is worried because he changed his e-mail at some point during this period and is not sure whether he provided an e-mail address on any of the three POAs. How can he achieve his goal of ensuring that he does not miss seeing any notices sent to his clients?

Answer

CRTP Hans should first review the POAs that were originally signed in 2020, 2021, and 2022 by logging onto the MyFTB portal. Using this system, Hans will be able to see on his client list the details of the POAs previously submitted for all three clients. He will then be able to submit new POAs with any changed information, using Form FTB 3520-PIT to replace the previous Form FTB 3520 for each client.

Taxpayer Responsibility

It is the taxpayer's responsibility to revoke a POA or ensure that it has been revoked when the taxpayer no longer wants to grant access to the indicated representative.

FTB 3912 Power of Attorney – Active Representatives on File Letter

In September 2021, the FTB started sending letters to taxpayers with active POA declarations on file with the FTB, informing such taxpayers of all their active POA representative relationships on their FTB accounts.

The primary objective of the new FTB 3912 is to ensure that taxpayers are well-informed about their POA relationships. It includes details about the level of online access (limited or full) granted to each representative in MyFTB, as well as the expiration date of the declaration. This form should not be returned to FTB to revoke a POA. If a revocation is necessary, either the taxpayer or the representative must take one of the following actions:

- Log in to your MyFTB account online to view, edit, or revoke your POA Declaration(s).
- Call the FTB at 1-800-852-5711 and provide the associated Declaration ID number for reference.
- Complete the FTB 3520 RVK, Power of Attorney Declaration Revocation form and send it to the FTB.

Practice Tip for the Tax Pro

Additionally, a representative who is no longer working with a particular taxpayer should revoke the POA to ensure against receiving confidential information to which there is no longer a right. The FTB does not automatically revoke POA declarations with overlapping periods.

FTB Assessments of Additional Tax

If a taxpayer receives a notice that the FTB is going to assess additional tax, a taxpayer or representative may request a 30-day deferral. The "quick resolution" option is available to the taxpayer or to another MyFTB user with an active POA declaration for the year of the FTB's proposed assessment of additional tax. Such a deferral provides the taxpayer with an additional 30 days to file an updated, valid tax return.

Response to Proposed Assessment

- ○ **I do not wish to protest - I will file the required valid tax return by 11/08/2017.**
- ○ **I do not wish to protest - I request a 30-day deferral to file the required valid tax return.**
- ○ **I do not wish to protest - I already filed the required valid tax return.**
- ○ **I wish to protest - I disagree with the proposed assessment.**

Electronic Signatures

The FTB accepts electronic signatures for individual e-filed returns and stand-alone electronic funds withdrawal (EFW) payment requests.

This chart below explains the taxpayer's and electronic return originator's (ERO) responsibilities when using each of the signature options.

Options	Taxpayer must	ERO must	Notes
Practitioner PIN	Review and sign California e-file Signature Authorization for Individuals (FTB 8879) or California Electronic Funds Withdrawal Payment Signature Authorization for Individuals and Fiduciaries (FTB 8879 (PMT))	Review and sign California e-file Signature Authorization for Individuals (FTB 8879) or California Electronic Funds Withdrawal Payment Signature Authorization for Individuals and Fiduciaries (FTB 8879 (PMT))	Shared secret (prior year California AGI) is generally not required
Self-select PIN	Enter his or her PIN on your computer Provide his or her shared secret (prior-year California AGI)	Enter his or her PIN on your computer Provide his or her shared secret (prior-year California AGI)	No paper forms required
FTB 8453	Review, sign, and retain California e-file Return Authorization for Individuals (FTB 8453) or California Payment for Automatic Extension and Estimate Payment Authorization for Individuals (FTB 8453 (PMT))	Review, sign, and retain FTB 8453 or FTB 8453 (PMT)	No shared secret, FTB 8879, or FTB 8879 (PMT) required

Electronic Filing Requirement

California law requires tax preparers to e-file if they prepare:

- more than 100 individual income tax returns
- one or more returns using tax preparation software

Summary

This chapter has covered the latest changes in California tax law up to and including its 2022–2023 legislative session, as well as federal and state coronavirus-related stimulus legislation. We have also discussed areas of conformity and non-conformity between California and federal tax rules. Key provisions in California Public Law 117 were highlighted, and we reviewed important changes made in 2021 and 2022.

Topics were selected based on their relevance to the 2023 and 2024 California filing seasons. By completing this chapter, you should now have a good understanding of recent federal tax law changes and areas of California conformity and partial conformity, as well as proper procedures for powers of attorney, accessing MyFTB as a CRTP, and related issues. With this knowledge, you can better serve your clients and ensure they are compliant with California tax law.

Important points to remember include the following:

- **RMD age**: California conforms to increased RMD age and lower RMD penalties: California follows the federal rules increasing the RMD age to 73 for those turning 72 after 12/31/22 and reducing the penalty for failure to take RMDs from 50% to 25%.
- **Access to MyFTB**: Preparers need valid ID numbers like a PTIN, CPA license, or EA number andclient consent via a POA to access MyFTB and represent taxpayers.
- **ABC test**: The ABC test requires workers be classified as employees by default: California's ABC test means workers are employees entitled to protections like minimum wage unless proven to be independent contractors.
- **California nonconformity:** Certain income like foreign earned and CODI is treated differently by California. Foreign earned income excluded federally must be included in CA. CODI like cancelled student loans may also get different CA treatment.
- **Distributions from 529 plans**: 529 plan distributions to a Roth IRA are taxable and penalized in California. If a 529 plan is distributed to a Roth IRA after being held for 15 years, California taxes the distribution and applies a 2.5% penalty while federal law allows tax-free rollovers.

Chapter 2. California Taxes and Taxing Agencies

Introduction

Like many other states in the union, the state of California has its own system of taxation, separate and in addition to the U.S. federal tax system.

First, it is important to know that taxes are levied by various governmental agencies at the state and local levels on taxpayer income, payroll, and real property. Additional taxes apply to transactions, such as sales and purchases of property, exchanges of property, and the transfer of property from one party to another by gift or inheritance. California tax practitioners are called upon to have a broad knowledge and understanding of the tax system in order to serve their clients effectively and ensure compliance.

This chapter provides an overview of the many types of tax that could be imposed on a California taxpayer.

Chapter Objectives

After completing this chapter, you will be able to:

- identify key tax rates applicable to California taxpayers
- recall specific agencies that regulate the tax regime in California
- recall various fees and taxes taxpayers are subject to, including disability taxes and tax administration fees

Taxes and Taxing Agencies

Depending on their individual personal circumstances, California taxpayers may be liable for some or all of the following types of taxes, each of which is administered by the indicated agency.

Tax	Tax Administrator
Federal income tax	United States Internal Revenue Service
Federal gift and estate tax	United States Internal Revenue Service
California income tax	California Franchise Tax Board
California payroll tax	California Employment Development Department
California sales and use tax	California Department of Tax and Fee Administration
California property tax	County tax assessors
California gift and estate tax	California Franchise Tax Board

California Personal Income Tax (PIT)

The state of California taxes residents on their worldwide income regardless of its source. Taxpayers who are deemed to be "nonresidents" for California tax purposes are taxed on any income they derive from California sources, regardless of whether they set foot in the state during the year. Over the years, many seasonal visitors to California have found themselves presented with large and unexpected tax liabilities. The FTB is responsible for administering the state income tax program.

Tax Forms

It is worth mentioning the primary tax forms you, as a tax preparer, will need fairly regularly in preparing your clients' tax returns.

For individual income tax reporting, the California forms are 540, 540NR, 540 2EZ, and 540 ES. These forms are essentially the state versions of the federal 1040, 1040-SR, and 1040 EZ. For both federal and California tax purposes, the "individual" returns are for single persons and for married persons filing together. These forms are called individual tax returns.

For federal tax, you should be familiar with Schedules A through F and numerous others. California's corresponding form is Schedule CA 540. On the schedules, you will find the information you need to enter items that increase and decrease a taxpayer's tax liability based on the complex federal and state rules you are about to review.

FEDERAL		CALIFORNIA	
Form	**Coverage**	**Form**	**Coverage**
Form 1040	U.S. Individual Income Tax Return	Form 540	California Resident Income Tax Return
Form 1040-SR	U.S. Tax Return for Seniors	Form 540NR	California Nonresident Income Tax Return
Form 1040-EZ	- No longer used -	Form 540 2EZ	California Resident Income Tax Return
Form 1040 X	Amended Individual Income Tax Return	Schedule X	Explanation of Amended Return Changes

Schedules A–F, etc.	Itemized deductions, etc.	Schedule CA 540	California djustments - Residents
Schedules SE, etc.	Self-Employment Tax, etc.	Schedule CA 540NR	California Adjustments - Nonresidents
Form 1040-ES	Estimated Tax for Individuals	Form 540-ES	Estimated Tax for Individuals

The federal form W-2, Wage and Tax Statement, is what the taxpayer will receive from his or her employer, indicating wages paid, payroll tax withheld, federal income tax withheld, and certain other information. Information returns—Form 1099s—are also relevant in many taxpayers' situations in calculating their income tax, indicating income from sources not providing a W-2. These federal forms are used for both federal and state tax return completion.

Income Tax Rates

The personal income tax is levied on the income of California residents and on income that nonresidents earn within California. There is no taxable wage limit or maximum tax. The withholding rate for each taxpayer is determined based on the taxpayer's filing status and number of withholding allowances. The primary focus of this course is the personal income tax.

When beginning a personal income tax return, a tax preparer must correctly apply rules related to the individual's residency status (resident, nonresident, and part-year resident) and filing status (single, married filing jointly, married filing separately, head of household, and qualifying widower).

Taxpayers who are subject to California income tax are taxed on a progressive scale, starting with their first dollar of income through $9,325 at a rate of 1 percent. The rate rises through a series of income brackets depending on the taxpayer's filing status, eventually culminating in a maximum marginal rate of 12.3 percent, with an additional 1 percent "millionaire tax" applicable to income in excess of $1 million. New Jersey and Hawaii also have double-digit income tax brackets.

Personal income tax brackets in California are indexed from January 1 each year based on the rate of inflation during the preceding 12-month period from July 1 to June 30. Income tax rates are shown in the following tables.

2023 Tax Year California Tax Rate Schedules

The tax rate schedules, which are based on filing status, are provided below. These tables are available upon request from the Franchise Tax Board before they are published on the FTB website.

	If the amount on Form 540, line 19 is over –	but not over –	Enter on Form 540, line 31			of the amount over –
Schedule X – Use if your filing status is **Single or Married/RDP Filing Separately**	$ 0	$ 10,412	$ 0.00	+	1.00%	$ 0
	10,412	24,684	104.12	+	2.00%	10,412
	24,684	38,959	389.56	+	4.00%	24,684
	38,959	54,081	960.56	+	6.00%	38,959
	54,081	68,350	1,867.88	+	8.00%	54,081
	68,350	349,137	3,009.40	+	9.30%	68,350
	349,137	418,961	29,122.59	+	10.30%	349,137
	418,961	698,271	36,314.46	+	11.30%	418,961
	698,271	AND OVER	67,876.49	+	12.30%	698,271
Schedule Y – Use if your filing status is **Married/RDP Filing Jointly or Qualifying Surviving Spouse/RDP**	$ 0	$ 20,824	$ 0.00	+	1.00%	$ 0
	20,824	49,368	208.24	+	2.00%	20,824
	49,368	77,918	779.12	+	4.00%	49,368
	77,918	108,162	1,921.12	+	6.00%	77,918
	108,162	136,700	3,735.76	+	8.00%	108,162
	136,700	698,274	6,018.80	+	9.30%	136,700
	698,274	837,922	58,245.18	+	10.30%	698,274
	837,922	1,396,542	72,628.92	+	11.30%	837,922
	1,396,542	AND OVER	135,752.98	+	12.30%	1,396,542
Schedule Z – Use if your filing status is **Head of Household**	$ 0	$ 20,839	$ 0.00	+	1.00%	$ 0
	20,839	49,371	208.39	+	2.00%	20,839
	49,371	63,644	779.03	+	4.00%	49,371
	63,644	78,765	1,349.95	+	6.00%	63,644
	78,765	93,037	2,257.21	+	8.00%	78,765
	93,037	474,824	3,398.97	+	9.30%	93,037
	474,824	569,790	38,905.16	+	10.30%	474,824
	569,790	949,649	48,686.66	+	11.30%	569,790
	949,649	AND OVER	91,610.73	+	12.30%	949,649

Mental Health Tax

California also assesses a 1 percent mental health tax on income over $1,000,000 ($500,000 for married/RDP filing separately). For these high-income taxpayers, the true marginal tax rate is 13.3 percent. That is, for each dollar of income over $1,000,000, the state of California is entitled to 13.3 cents.

This tax is often referred to as the “millionaires’ tax.”

Capital Gains Tax

While the federal rules provide preferential tax rates for capital gains versus ordinary income, California makes no such distinction. California capital gains are taxed at California’s ordinary income tax rates (1 percent to 12.30 percent).

Federal capital gains tax rates are 0 percent, 15 percent, and 20 percent.

California capital gains tax rates can be as much as 13.3 percent for tax year 2023—capital gains are taxed at California’s ordinary income tax rates.

Capital gains and losses are reported for federal purposes on Form 1040 and Schedule D to Form 1040, and the adjustments needed due to California’s treatment of this income must be made on California Schedule D of Form 540.

Example

Jean, a California resident, has $75,000 in long-term capital gains. What is her possible California income tax liability?

Answer

Jean's capital gains will be taxed by California at Jean's ordinary income tax rate (up to 13.3 percent). Capital gains and losses are reported for federal purposes on Form 1040 and Schedule D to Form 1040, and the adjustments needed due to California's treatment of this income must be made on California Schedule D of Form 540.

Knowledge Check

Test Your Knowledge!

What is the maximum marginal tax rate in California?

10 percent

This answer is incorrect. The maximum marginal tax rate in California is not 10 percent.

12.3 percent

This answer is incorrect. While 12.3 percent is the highest tax bracket, it does not account for the additional 1 percent "millionaire tax" on income over $1 million.

13.3 percent

Correct. The maximum marginal tax rate in California is 13.3 percent, which includes the 1 percent "millionaire tax" on income over $1 million.

15 percent

This answer is incorrect. The maximum marginal tax rate in California is not percent.

EDD Payroll Tax

The California Employment Development Department (EDD) administers four different payroll taxes:

- Unemployment Insurance Tax (UI)
- Employment Training Tax (ETT)
- State Disability Insurance Tax (SDI)
- Personal Income Tax (PIT)

Workers and employers bear responsibility for different parts of payroll tax, with some amounts being withheld from wages and other amounts contributed by the employer. All such funds are remitted periodically by the employer to the state of California.

Unemployment Insurance Tax

The United States Department of Labor administers a national unemployment insurance program under the Social Security Act. This program is intended to provide temporary payments to persons who become unemployed through no fault of their own.

The employer is responsible for unemployment insurance tax, which is assessed by the **federal government at a rate of 6 percent of any employee's first $7,000** of wages for the year. The annual federal unemployment tax is the employer's responsibility.

California also assesses a tax for unemployment insurance (UI) at a rate that varies each year depending on whether an employer has existed long enough to have what is called an "experience rating" and what that experience rating is once assigned. That is, a new employer is generally assessed 3.4 percent of each employee's first $7,000 in wages for the first two to three years. In subsequent years, the rate is based on the employer's history of unemployment claims and hiring records, and it ranges from 1.5 percent to 6.2 percent.

Voluntary UI Payments

In many states, including California (in most years), employers can reduce their unemployment tax rates by making voluntary unemployment contributions.

The UI rate schedule (Schedule F) can be found on the EDD website. For 2023 and 2024, the relevant EDD document is Schedule F+. This schedule includes a 15 percent emergency surcharge. In years that F+ is in effect, there is no voluntary UI program for employers to participate in.

Employment Training Tax

The California Employment Training Tax (ETT) is designed to provide funds to train employees in selected industries for the purpose of improving the competitiveness of California businesses.

Similar to the UI tax, the employment training tax is paid by the subject employer based on a percentage of each employee's wages. Whether a specific employer is subject to this tax is determined according to the California Unemployment Insurance Code.

For 2023 and 2024, the rate is 0.1 percent of the first $7,000 of the wages paid to each employee in a calendar year. The current maximum per employee is $7 per year.

State Disability Insurance Tax

The **State Disability Insurance (SDI)** tax supports a California program providing temporary benefit payments to workers with disabilities not related to or caused by their jobs. The SDI tax also provides **paid**

family leave (PFL) benefits, which can be used by persons who are unable to work because of their need to care for a seriously ill family member or new child.

The SDI tax is deducted from an employee's wages based on a percentage that may be changed annually by the California state legislature.

The 2023 and 2024 SDI withholding rate is 1.10 percent. Prior to the 2023 tax year, there was a taxable wage limit ($153,164) for 2023.

Senate Bill 951 removes the taxable wage limit and maximum withholdings for each employee subject to SDI contribution requirements.

Voluntary Plan for Disability Insurance (VPDI)

There is also a Voluntary Plan for Disability Insurance (VDPI), which is not deductible on the federal return. The VPDI assessment rate is 14 percent of the state DI contribution rate multiplied by taxable wages. In 2023 and 2024, VPDI employers are assessed at 0.00145 (14 percent of 0.011) of VPDI taxable wages. If a taxpayer ends up paying more SDI/VDPI than is owed, claiming the excess requires filing Form 540 or 540NR. The short-form 540 2EZ tax return cannot be used to claim this credit.

Business Licenses

In order to manage sales and use tax collections, which will be described shortly, there are various business license requirements for doing business in California. It is no surprise, then, that tax clients often have questions about what licenses and permits they need in order to conduct business in California. There are general business licenses, specific licenses required for regulated professions and industries, seller's permits, business entity registrations, and many other compliance issues. A good place to start in determining which licenses need to be filed is the CalGold website at www.calgold.ca.gov, which is run by the governor's Office of Business and Economic Development. Basic business entity registration can generally be accomplished through the California Secretary of State website at www.sos.ca.gov.

For purposes of this training, the most likely licensing-related issue you and your clients will run into is the need for seller's permits. Information about these permits can be found on the California Department of Tax and Fee Administration (CDTFA) website at www.cdtfa.ca.gov/services. The CDTFA manages sales and use tax accounts as well as numerous special tax and fee programs (including, for example, cannabis taxes, fire prevention fees, motor vehicle fuel tax, and the natural gas surcharge, to name a few).

California Sales and Use Tax

Sales and use tax represent a significant cost of doing business in California. If a business is selling anything in California, the business must register and obtain a seller's permit to ensure that sales tax is collected. The specific guidelines for determining whether such a permit is required are as follows:

- companies "engaged in business in California," which is defined very broadly

- businesses selling or leasing tangible personal property that would ordinarily be subject to sales tax if sold in a retail setting, including wholesalers, manufacturers, and retailers themselves

Even a business making sales for a temporary period must set up a sales tax account. The CDTFA administers this program.

Example

Sierra opens a retail clothing shop in Los Angeles. What is one of the first things she needs to do for this business?

Answer

Sierra must register for a seller's permit with the CDTFA to collect sales tax from customers on their clothing purchases from her store.

For transactions to which sales tax does not apply, California can levy the Use Tax to capture revenue for the state's general fund and for cities, counties, and other local jurisdictions through specific fund allocations. A use tax account is required for a business with at least $100,000 in annual gross receipts—gross receipts from both in-state and out-of-state operations.

Some items are exempt from Sales and Use Tax. Common exemptions are associated with the following:

- sales of certain food products for human consumption
- sales to the U.S. government
- sales of prescription medicine

More information can be found in the CDTFA's website.

The sales tax rates are the same as the use tax rates. As of October 16, 2023, the general statewide rate for Sales and Use Tax is 7.25 percent. Most local jurisdictions have added district taxes that increase the tax owed by a seller. These range from 0.10 percent to 1 percent. Some areas may have more than one district tax in effect.[3]

Bradley-Burns Tax

The CDTFA also collects the Bradley-Burns tax on behalf of cities and counties and distributes the revenue to those local governments. The Bradley-Burns tax imposes a statewide rate of 1.25 percent, of which 1 percent is allocated to counties or incorporated cities to use at their discretion, and the remainder is distributed to county local transportation funds to support transportation programs.

More information can be found in the CDTFA's publication, "Sales and Use Taxes: Exemptions and Exclusions."

Property Taxes

California has one of the highest average property tax rates in the country, and each of the 58 counties in the state is responsible for collecting property taxes within its borders. Counties in California collect an average of 0.73 percent of a property's assessed fair market value per year. Each county in California sets and applies an assessment rate to property based on the value of that property according to the county assessor in each case. This leads us quite logically to the next question that is also often asked annually by homeowners: How does the county assessor calculate the value of each property?

Although some disgruntled homeowners may think that their local county assessor makes up his or her own rules, there are clear statewide policies and guidelines. A property's "fair market value" is defined as the price that a buyer would be willing to pay and a seller would be willing to accept, assuming both have full information about the property in question and are engaged in arms-length negotiations.

There are limits on the rate of property tax that can be charged, as well as limits on how much property tax can be increased from one year to the next.

Knowledge Check

Test Your Knowledge!

Who is responsible for administering the California payroll tax?

the California Franchise Tax Board

This answer is incorrect. The California Franchise Tax Board administers income and gift and estate taxes, not payroll taxes.

the United States Internal Revenue Service

This answer is incorrect. The United States Internal Revenue Service administers federal taxes, not state payroll taxes.

the California Department of Tax and Fee Administration

This answer is incorrect. The California Department of Tax and Fee Administration administers sales and use taxes, not payroll taxes.

the California Employment Development Department

Correct. The California Employment Development Department administers the California payroll tax.

Alternative Minimum Tax

When calculating California or federal income tax, it is important to remember the alternative minimum tax (AMT). A taxpayer sometimes owes this "alternative" tax so that he does not game the system to pay too little tax. In California, the rate is 7 percent of what is called an "alternative minimum tax base." The taxpayer or preparer starts with taxable income and adds to or subtracts from that amount for an AMT exemption allowance and certain adjustments and preferences.

Certain deductions only apply after a certain income threshold. One of the adjustments is based on medical expenses. For California AMT purposes, the unreimbursed medical expense threshold is 10 percent.

The alternative minimum tax is added to regular tax. It is equal to any excess of tentative minimum tax (TMT) over the regular tax for that tax year. In California, “regular tax” for AMT purposes is income tax before any credits are applied.

Federal AMT

For federal purposes, the AMT rules and procedures are provided in the instructions to Form 6251. The basic steps are to make adjustments to the taxable income amount that has been computed using the regular rules and make adjustments to this figure in order to arrive at the “tentative minimum taxable income” (TMTI). Then the AMT exemption amount is subtracted, and the remaining amount is subject to tax at AMT rates. In some situations, a taxpayer might have an AMT foreign tax credit.[4]

More specifically, the steps for computing tentative minimum tax are as follows:

1. Compute taxable income for AMT purposes by taking away some of the deductions (etc.) made using regular tax rules.
2. From this figure—from the alternative minimum taxable income—subtract the AMT exemption amount.
3. Multiply the remaining amount (the excess over the AMT exemption) by the AMT rate. In some instances, capital gains rates can be used if these rates are lower than the otherwise applicable AMT rates.
4. Subtract the AMT foreign tax credit.

Federal AMT Exemption and Phase-Out Threshold 2023			
Filing Status	Exemption Amount	Phase-Out Begins	Phase-Out Ends
Single or HOH	$81,300	$578,150	$903,350
MFJ or Surviving Spouse	$126,500	$1,156,300	$1,622,300
Married Filing Separately	$63,250	$578,150	$831,150
Estates and Trusts	$28,400	$94,600	$208,200

California AMT

The California AMT is calculated as follows:

1. Start with regular California net income after state adjustments.
2. Reduce or increase this figure based on AMT preferences and adjustments in order to arrive at pre-adjustment AMTI.
3. Make adjustments for depreciation, according to the ACE rules (Adjusted Current Earnings), and for NOLs.
4. Reduce this amount by $40,000.

5. Multiply this figure by 6.65 percent for individuals (8.65 percent for corporations) to arrive at the tentative minimum tax (TMT).
6. Compare this figure with the tax calculated using regular tax rules.
7. The higher of these two figures indicates the tax liability.

As you have seen in other areas of income tax law, certain deductions only apply after a certain income threshold. One of the adjustments is based on medical expenses. For California AMT purposes, the unreimbursed medical expense threshold is 10 percent.

Apportionment

For a California nonresident or part-year resident, a preparer would multiply the AMTI by a ratio to isolate the appropriate California income to consider. The AMT includes all parts of AMTI during California residency and/or California-source income.

Carryovers, deferred income, suspended losses, and suspended deductions are allowed to the degree they came from California-source income.

For regular tax, there are certain deductions that carry over: NOLs, capital losses, investment interest expense, and others. Consideration of these items gets complicated. For the AMT, these same items are treated differently. Calculations may be determined by filling out draft forms for the applicable tax twice. The draft forms should just be used to calculate—not to send with the return.

California is different from the IRS in counting personal exemptions for AMT purposes. Only the standard deduction is disallowed. California also allows certain credits to reduce a taxpayer's regular tax amount below the TMT (after an allowance for the minimum tax credit). Some of these credits are as follows:

- nonrefundable renter's credit
- credit for excess unemployment compensation contributions
- credits for taxes paid to other states
- credit for withheld tax
- personal, dependent, blind, and senior exemption credits
- adoption costs credit
- California earned income tax credit (EITC)
- credits for qualified joint custody, head of household, and a qualified taxpayer with a dependent parent
- senior head of household credit

To get to the alternative minimum tax, a preparer must first calculate the AMTI. The AMTI represents regular taxable income, reduced by certain things and increased by certain things. Qualified taxpayers exclude their trade or business's income, adjustments, and tax preference items.

Personal Property Taxes and Real Property Taxes

A taxpayer's AMTI should include certain items from federal Schedule A:

- state and local personal property taxes
- state, local, or foreign real property taxes

- home mortgage interest for non-purchase-money mortgage loans (home equity loans)

Credit for Prior Year Minimum Tax

When a taxpayer has had California AMT in earlier years but not in the tax year, there is a carryover credit. The California credit is calculated the same way as the federal credit—just with California figures instead of federal figures. Both taxing authorities base AMT credits on the amount of AMT paid on items that defer tax (deferral preferences) but not items that permanently reduce tax (exclusion items). Unused credits may be carried forward indefinitely.

Exemption for Small Businesses

Federal law disallows the standard deduction and the deduction for personal exemptions for AMT calculation. California disallows only the standard deduction. California also departs from federal law and excludes from AMTI the income, adjustments, or items of tax preference attributable to a trade or business of a taxpayer who has an ownership interest in a trade or business or has gross receipts (less returns and allowance) of under $1 million. This $1 million is the limit for the aggregation of all trades or businesses in which the taxpayer has an ownership interest. Understandably, the California computation only includes the proportion attributable to nonresidents with California business or California-source income and to residents. The gross receipts figure includes both business and nonbusiness income. This $1 million limit applies to all filing statuses.

Franchise Tax

Any corporation "doing business in California" is subject to the minimum franchise tax even if the corporation has not gone through qualification processes with the California Secretary of State (SOS) (e.g., in situations not requiring a physical presence in California so that no SOS entity creation filings are required). A business entity engaging in activity for financial gain is considered to be doing business in California. Completing business transactions in California, having a limited partner in a limited partnership transacting some sort of business in California, etc., are some types of activities that would subject a foreign (out-of-state) corporation to California franchise tax and to California income tax.

The annual franchise tax is $800.

For Limited Liability Companies, Limited Liability Partnerships, and Limited Partnerships that organize, register, or file with the California Secretary of State between January 1, 2021, and January 1, 2024, there is a first-year exemption from this tax. Prior to AB 85, only corporations had this first-year exemption.[5]

Summary

This chapter provided an overview of key California state and local taxes, including personal income tax, payroll taxes, sales and use tax, and property tax. The Franchise Tax Board, Employment Development

Department, Department of Tax and Fee Administration, and county assessors administer these taxes. Capital gains are taxed at ordinary income rates of up to 13.3 percent. The alternative minimum taxapplies a 7 percent rate to alternative minimum taxable income.

More specifically, we covered the following:

- state and local agencies responsible for collecting the taxes typically paid by Californians
- state payroll taxes that are withheld from employees' salaries
- property taxes and sales/use taxes
- income tax rate tables
- mental health tax
- capital gains tax
- California alternative minimum tax
- other taxes paid in California

Chapter 3. Residency

Introduction

A tax preparer must evaluate whether a person is required to file a California income tax return and to identify the income subject to California taxation. To that end, the taxpayer's residency status must be selected. To make this determination, there are three factors to consider:

- whether the person is a resident, part-year resident, or nonresident with California-source income
- whether the person is required to file a federal return
- whether the person's income exceeds certain thresholds

Chapter Objectives

After completing this chapter, you will be able to:

- identify rules and filing requirements for residents, part-year residents, and nonresidents
- recall the taxable treatment of income sources based on one's residency status
- identify rules and filing requirements specific for military servicemen and their spouses

Categories

For California income tax purposes, every taxpayer can be classified into one of the following categories:

- resident
- nonresident (whose California-source income is subject to California taxation)
- part-year resident

California taxes all income from all sources during the portion of a year that a person is a California resident. The state taxes only California-source income while a person is a California nonresident. That is, California can reach the income of persons while they are living in the state and of persons who live outside the state but earn income from California sources.

Resident

A California resident is an individual who:

- is present in California for reasons other than a temporary stay or because he or she is in transit to another destination
- has his or her domicile in California but is physically outside California for a temporary stay or because he or she is in transit to another destination

Example

Jenny relocated permanently to Long Beach with her family in 20X3. Assuming she remains a resident for all of 20X4, she will be a California resident for tax purposes for tax year 20X4. All of her income from all sources will be subject to California income tax for the entire year.

Domicile

Domicile is a concept closely intertwined with residency. In California, the term “domicile” has a special legal definition that sets it apart from the term “residence.” In some states, these terms are used interchangeably.

For California tax purposes, a domicile is defined as the place where someone voluntarily establishes him or herself and family, not simply for a special or limited purpose, but with a current intention of making it her or his true, fixed, permanent home and main place of residence. It is the place where he or she intends to return to after being absent.

A taxpayer can have only one domicile at a time. Once he or she acquires a domicile, it is retained until he or she acquires another. This means that moving from one place to another will be treated as a change of domicile when the taxpayer takes all of the following actions:

- abandons the prior domicile
- physically moves to the new locality and resides there
- demonstrates by his or her actions the intent to remain in the new locality permanently or indefinitely

A residence is a dwelling abode that has some permanency beyond a merely temporary lodging place. In most cases, an individual’s domicile and residence will be the same physical location. The main difference between a domicile and a residence is the intent of the individual regarding the location that he or she intends to make a home, either permanently or indefinitely. As mentioned, California recognizes only one domicile at a time for any taxpayer.

The following examples help to clarify California’s distinction between the two terms.

Examples

Example 1

Wade is domiciled in Texas and comes to Los Angeles on business. His intention is to return to Texas as soon as his project in California has been completed. While in California, he maintains a home in Los Angeles and stays in California for ten months.

Residency Determination

Wade retains his Texas domicile because his stay in California was for a limited purpose.

Example 2

Sherry moves from Oregon to California in September of 2023 to begin a permanent job. She sells her home in Oregon and buys a home in California. She moves all of her personal belongings to California,

opens a California bank account, and gets a California driver's license. She has no intention of returning to Oregon.

Residency Determination

Sherry became a California domiciliary in September of 2023 when she moved to California. She came to California with the intention to remain there indefinitely with no fixed intention of returning to Oregon.

Example 3

Cindy and her husband, Mark, were both born and raised in California. Mark obtained employment in San Jose right after his graduation from a California college in 2012. In 2022, Mark was sent to Australia for a one-year assignment. While Mark is away, Cindy remains at their California home with their two children. While living and working in Australia, Mark rents an apartment and joins a local social club. He returns to California in 2023.

Residency Determination

Mark remained domiciled in California throughout his absence. He maintained his ties with California, and the ties he established with Australia did not demonstrate that he intended to remain there permanently.

Government Officials

The California Revenue and Taxation Code (CRTC) provides a special rule for certain U.S. government officials and their spouses. If those individuals have a California domicile, their absences from the state are considered to be temporary or transitory. Thus, such taxpayers remain California residents for taxation purposes.

This rule applies to the following persons:

- any elected U.S. official
- anyone on the staff of a member of the U.S. Congress
- any presidential appointee, subject to Senate confirmation, other than military and foreign service career appointees

Nonresident

As a popular tourist destination with temperate winter weather, the state of California attracts numerous short- and long-term visitors every year. Snowbirds, tourists, and other visitors usually qualify as nonresidents. To be a nonresident, a person:

- *must be* domiciled outside California and maintain a permanent place of residence at the domicile location
- *must not* take part in any activities or engage in any other conduct within California beyond what is normally expected of a seasonal visitor, tourist, or guest

Regular visitors to the state can normally be expected to establish some ties to California, but the following connections will not, in and of themselves, cause an individual to lose his status as a seasonal visitor, tourist, or guest:

- owning or maintaining a home
- opening a bank account for the purpose of paying personal expenses
- holding membership in local social clubs

The California Code provides clarification about the tax treatment of such visitors by setting out the conditions under which they will be considered nonresidents of the state. It says, in essence, that an individual who is physically present in California for a total of six months or less in a tax year will be considered as being in the state for temporary or transitory purposes provided he or she meets the following conditions:

- simply passing through the state
- in California for a brief rest
- in California for a vacation
- in California for a short period to complete a particular transaction, perform a particular contract, or perform a particular engagement

Example

Grant resides in San Diego until 2024, when he is transferred by his company to take a new job in New York. He is a California nonresident for tax purposes in 2025.

Part-Year Resident

A part-year resident is an individual who qualifies as a California resident for part of the year and as a nonresident for the remainder of the year.

Example

John lives in San Francisco but is laid off from his job in 2024. After six months of searching, he finds a new job in Texas and relocates there in February 2025. He is a California part-year resident for tax purposes in 2025.

Closest Connections

In general, a person is a resident of California if California is the place where that person has his or her "closest connections."

A number of factors are examined to determine taxpayer residency status. Some factors to consider when determining residency for a client are as follows:

- the amount of time the client spends in California versus the amount of time he or she spends outside California
- the location of the client's spouse or registered domestic partner (RDP) and children
- the location of the client's principal residence

- the state that issued the client's driver's license
- the state where the client's vehicles are registered
- the state in which the client maintains his or her professional licenses
- the state in which the client is registered to vote
- the location of the banks where the client maintains accounts
- the origination point of the client's financial transactions
- the location of the client's doctors, dentists, accountants, attorneys, and other professional service providers
- the location of the client's social ties, such as the client's place of worship, professional associations, or social and country clubs of which he or she is a member
- the location of the client's real property and investments
- the permanence of the client's work assignments in California

Tax practitioners will need to compare their clients' ties to California with their ties to other places. When making use of these factors, practitioners should bear in mind that a client's residency is determined by the strength of his or her ties, not simply the number of ties. The above list suggests some of the factors to consider. Additional factors could apply to any specific client's situation in determining residency status.

When a taxpayer departs from his or her state of residence, it is important to determine whether the client's presence in a different state or country is for a "temporary or transitory purpose." The purpose and length of the taxpayer's stay must also be considered when determining residency.

Taxpayers Entering California

Anyone who is present in California only for temporary or transitory purposes is considered a nonresident of California. For example, a taxpayer who passes through LAX airport on the way to a vacation in Hawaii or who comes to California for a vacation at the beach or to buy a car is generally considered as having a temporary or transitory purpose for being in California. As a non-resident, that taxpayer is taxed only on his or her income from California sources.

On the other hand, a taxpayer who is present in California for other than a temporary or transitory purpose is considered a resident of California. For example, a taxpayer who is assigned by his employer to an office in California for a long or indefinite period, or who retires and comes to California with no specific plans to leave, or who is ill and is in California for an indefinite recuperation period can be said to be in California for a purpose that is other than temporary or transitory. As a resident, that taxpayer is taxed on income from all sources.

Even though a taxpayer may have connections with another state, he or she is regarded as a California resident if his or her stay in California is for other than a temporary or transitory purpose. As a resident, the taxpayer will have all income from all sources within reach of the California taxing authority.

Incoming Taxpayer Examples

The following questions and answers will provide some insight into the classification of individuals who enter California.

Examples

Example 1

David is a sales engineer who lives in Connecticut with his family. Every three months, he travels to other states to visit his clients. His average stay in each location is one or two weeks, and the total time spent in California for any taxable year does not exceed six weeks. His family usually remains in Connecticut while he is away on business. How is David treated for California tax purposes?

Answer

Because his stays in California are temporary or transitory in nature, David is not considered to be a California resident. As a non-resident, he is taxed only on his income from California sources, which also includes his income for services performed in California.

Example 2

In November of 2023, Barbara moves to Los Angeles from Ohio on an indefinite job assignment. She rents an apartment in LA and continues to live there. She keeps her house and bank account in Ohio until March of 2024, at which time she sells her house and transfers her Ohio bank account to California. How is Barbara treated for California tax purposes for tax year 2024?

Answer

Barbara's assignment in California is for an indefinite period, which means that her stay in California is not of a "temporary or transitory nature." As a result, Barbara became a California resident upon entering the state in November of 2023, even though she maintained her ties in Ohio until March of 2024. For the 2024 tax year, Barbara is a California part-year resident (i.e., a non-resident until November and then a resident for the remainder of the year).

Taxpayers Leaving California

Any individual who leaves the state for a temporary or transitory purpose continues to be a resident of California for tax purposes. But as covered in the discussion about the safe harbor rules, a taxpayer who is absent from California under an employment-related contract for a period of at least 546 consecutive days may be considered to be an exception to the previous statement.

Departing Taxpayer Examples

The following questions and answers will provide some insight into the classification of individuals who leave California.

Examples

Example 1

Lonnie is a resident of California until October 20X1. At that time, he declares himself to be a resident of Idaho, where he has a vacation home. He keeps his home in California and continues to spend about six or seven months there each year. He spends only about three months each year in Idaho in between traveling to other states and countries. Although he has transferred his bank accounts to Idaho, he continues to maintain his golf club and business connections in California. How is Lonnie treated for California tax purposes?

Answer

Lonnie's action of declaring residency in Idaho does not by itself establish residency for him in that state. His closest connections are to California, he spends more time there than anywhere else, and his absences from California are for temporary or transitory purposes. As a result, Lonnie is a resident of California and is taxed on his income from all sources.

Example 2

Ginny and her husband Paul are California residents. Ginny accepts a contract to work in Chile for 14 months and leases an apartment near her office there. Meanwhile, Paul and the children will remain in California, living in the family home. Before accepting the job, Ginny makes sure that her contract states that her employer will arrange for her to return back to California at the conclusion of her assignment. How are Ginny and Paul treated for California tax purposes?

Answer

Ginny maintains strong ties with California because Paul and the children will remain in their California home during her absence. As guaranteed by her contract, Ginny's clear intent is to return to California, and her absence is temporary and transitory. Ginny remains a California resident during her absence outside the state. She and Paul are taxed on income from all sources, including income earned in Chile.

Example 3

Mauro receives and accepts a permanent job relocation to Brazil. He and his wife Fran sell their home in California, pack up their three children and all of their possessions and move to Brazil on June 2, 20X1. Mauro and Fran lease an apartment in Sao Paulo and then enroll their children in school. Mauro and Fran both obtain driver's licenses from Brazil and make a number of sporting and social connections in their new home. They have no intention of returning to California. How should Mauro and Fran be treated for California tax purposes in 20X1?

Answer

Mauro and Fran are part-year residents. Until June 1, 20X1, they had been California residents, but on June 2, 20X1, they became nonresidents. All of their income while they were California residents is taxable by California. But from the time Mauro and Fran became nonresidents, only income from California sources is taxable by California. The couple will file as part-year residents for the 20X1 tax year.

Example 4

Trevor is a resident of California and accepts a 15-month job assignment in Afghanistan. Trevor puts his personal belongings, including his car and motorcycle, in storage in California. Trevor is registered to vote in California and has a California driver's license. Trevor maintains his bank accounts in California while he

is out of the country and plans to return to California after completing his assignment. In Afghanistan, he stays in a compound provided for him by his employer, and the only ties he establishes there are connected to his employment. How is Trevor treated for California tax purposes?

Answer

Trevor has kept more connections with California than he has established in Afghanistan, and because he is on a fixed-term assignment, his absence is for a temporary or transitory purpose. As a result, Trevor remains a California resident while he is in Afghanistan. As a California resident, Trevor's income from all sources is taxable by California, including the income that he earns from his assignment in Afghanistan.

The Six-Month Safe Harbor

There are some guidelines as to where to draw the line for resident or temporarily absent versus nonresident who spends some time in California. The nine- and six-month rules are intended to remove the ambiguity that may arise from a taxpayer's presence in California for what he or she may consider a temporary purpose. This resident-nonresident distinction makes a significant difference in income tax owed to California.

For the person domiciled outside California but staying in California for an aggregated period of under six months (i.e., six months that are not necessarily consecutive) in a tax year, a six-month safe harbor could apply so that the taxpayer would be considered a non-resident. It is important to pay close attention to the purpose of the person's time in California. Activities should be consistent with those of a tourist or visitor. Regulations suggest that a tourist or visitor would limit activities to such things as owning a vacation home, keeping a California bank account to pay for expenses, and joining a country club. Engaging in any activity for profit would rebut the presumption that the taxpayer is a nonresident.

Example

Miriam is a single taxpayer and a resident of California. She accepts a two-year assignment in Fiji, covering the period from January 1, 2022, through December 31, 2023. Miriam rents out her condo and puts her car and other belongings in storage in California. She keeps her California bank accounts, voter registration, and driver's license. Miriam has less than $200,000 of intangible income during each of the two years of her contract. Her intention has always been to return to California after completing her assignment. Miriam returns to California on vacation for the months of July 2022 and June 2023. How is Miriam treated for California tax purposes?

Answer

Miriam meets the safe harbor rule because she was outside California on an employer-related contract for more than 546 uninterrupted days and did not return to California for more than 45 days in 2022 or 2023. She is therefore considered to be a nonresident during her absence from the state and will file a nonresident return.

The Nine-Month Rule

In contrast, a person spending more than nine months in California is presumed to be a California resident. The nine-month rule is intended as more of a guideline than a hard and fast rule. If an individual can provide satisfactory evidence that he or she is in the state for a temporary or transitory purpose, the presumption of residency that would otherwise take effect after nine months can be nullified.

It should be noted that this rule is only intended to apply to a taxpayer who has entered the state from another jurisdiction. It should not be assumed that a given taxpayer is automatically classified as a nonresident simply because he or she has been present in California for less than nine months. As we have already seen, under certain conditions, a taxpayer may be classified as a California resident even though he or she did not set foot in the state during the year.

Some common reasons for a person to be present in California for a temporary or transitory purpose are to vacation, to complete a transaction, or to pass through on the way somewhere else. Again, the key determinant of residency is the "temporary or transitory" character of the person's purpose. Some actions that might seem to speak toward a more permanent status—opening certain bank accounts (e.g., for personal expenses), owning a home, joining country clubs, etc.—do not by themselves contradict someone's purpose as being temporary or transitory.

The California Code of Regulations (CCR) provides a detailed discussion of the meaning of the term "temporary or transitory purpose." The CCR states that the facts and circumstances of each particular case greatly affect the determination of whether or not an individual is in California for a temporary or transitory purpose. An individual would be considered to be present for other than temporary or transitory purposes if he or she is in California:

- for retirement with no set intention to leave within a short period of time
- to recover from an illness or injury for an indefinite or relatively long period of time
- for a business purpose that will take an indefinite or relatively long period of time to accomplish
- for work in a position that may last for an indefinite period of time or permanently

The following examples provide insight on the "temporary or transitory purpose" analytical framework.

Examples

<u>Example 1</u>

Kevin and Sue are domiciled in Nebraska, where they have maintained their family home for five years. Kevin works for a large university, but in September of 2023, he takes a six-month leave of absence to become a temporary consultant for a California university. He and Sue move to San Diego in September of 2023, rent an apartment, and open a checking account. Meanwhile, their home in Nebraska is left vacant, and they retain their Nebraska bank accounts. They stay in California from September of 2023 until February of 2024 when they return to Nebraska.

Residency Determination

Kevin and Sue were in California for a short period for the purpose of Kevin completing a particular engagement as a temporary consultant. Kevin and Sue were in California for a temporary or transitory purpose; they will be considered nonresidents of California for tax purposes.

Example 2

Bill is domiciled in Kansas and has lived there for 40 years. Bill develops a serious medical condition related to his respiratory system. His doctor tells him to live in a warm climate near the ocean until he recovers, and recovery could take from several months to several years. Bob takes his doctor's advice and moves to southern California.

To avoid being considered a California resident for tax purposes, an individual:

Residency Determination

Bill is present in California for an indefinite period while he recovers from his illness. His stay in California is, therefore, not for a temporary or transitory purpose, so he will be considered a California resident for tax purposes.

To avoid being considered a California resident for tax purposes, an individual:

- *must be* domiciled outside California and maintain a permanent place of residence at the domicile location
- *must not* take part in any activities or engage in any other conduct within California beyond what is normally expected of a seasonal visitor, tourist, or guest

Regular visitors to the state can normally be expected to establish some ties to California, but the following connections will not by themselves cause an individual to lose his status as a seasonal visitor, tourist, or guest:

- owning or maintaining a home
- opening a bank account for the purpose of paying personal expenses
- holding membership in local social clubs

Example

Paul and Kathy live and work in Minnesota for 20 years until they retire in the summer of 2021. Starting in January of 2021, the couple spends four months each year in California. They return to Minnesota in the spring and spend the next eight months at their family home that they have owned since 1993. They both have valid Minnesota driver's licenses, are registered to vote in Minnesota, and maintain Minnesota bank accounts. Paul and Kathy also own a small California home they use during their annual stay in the state. For the sake of convenience, they also have a California checking account to use for their personal expenses. The couple are members of a California country club. Their time in California is purely leisure, and the two retirees do not engage in any California business activities.

Residency Determination

Paul and Kathy are considered to be seasonal visitors who are present in California for temporary or transitory purposes. As a result, they are nonresidents of California.

Residency Status Determinations

Some living situations do not fit neatly into a given category. The following examples demonstrate the appropriate analysis for determining residency status in several specific situations.

Residency Safe Harbor: Out of State for an Employment Contract

From what you have seen so far, it might appear that a taxpayer who leaves California temporarily without selling his or her home runs the risk of being taxed on all worldwide income by California, whether or not the taxpayer sets foot in the state. A safe harbor rule was created to address this situation for certain individuals who are domiciled in California but leave California under employment-related contracts meeting certain requirements. The FTB established this rule for tax years beginning on or after January 1, 1994.

The safe harbor allows for a taxpayer who is domiciled in California but who is outside California under an employment-related contract for an uninterrupted period of at least 546 consecutive days to be considered a nonresident unless one or both of the following two conditions are met:

- The taxpayer's intangible income exceeds $200,000 in any taxable year during which the employment-related contract is in effect.
- The taxpayer's main purpose for being absent from California is to avoid personal income tax.

A person's spouse or registered domestic partner will also be considered a nonresident while accompanying the taxpayer outside California for at least 546 consecutive days. Temporary return visits to California that do not exceed a total of 45 days during any taxable year covered by the employment contract will not prevent the taxpayer from being able to claim the benefits of the safe harbor rule.

As noted above, this safe harbor does not apply to a person who has intangible income of over $200,000 for an employment-related contract year, or the main purpose of being absent from California is personal income tax avoidance. And spouses or RDPs of persons covered by this safe harbor can also benefit from the rule unless any return visit to the state does not exceed a total of 45 days during the taxable year.

Note

"Intangible income" is defined in the California Code as income from such sources as rentals and royalties received from intellectual property and other intangibles and income from stock, bonds, notes, and similar non-wage sources. If these assets are connected to California, the income from such assets is taxable in California. Such a connection exists when the property is physically located in California, when transactions related to the property take place in California, or when such intangible assets are pledged as security for

the payment of debts incurred in the state. The source of gains and losses from the sale or other disposition of intangible personal property is determined at the time of the sale or disposition.

Example

Jane is a California resident when she enters into an installment agreement to sell intangible personal property. After receiving 2 of the 24 required payments, she becomes a nonresident. Gain attributable to future installment payments will generally be sourced to California (and therefore taxed by California).

The residency status of individuals who do not meet the requirements of the safe harbor is determined based on the facts and circumstances of each case. Taken on its own, an individual taxpayer's occupation, business, or vocation is insufficient for the determination of his or her residency status. Instead, all relevant information available is taken into account when determining residency status. For example, resident students who leave California to attend school in another state do not automatically become nonresidents, nor do nonresident students who come to California to attend school automatically become residents. In such situations, taxpayers must determine their residency status based on their individual facts and circumstances.

Safe Harbor Examples

The following questions and answers will provide some insight into the workings of the safe harbor rule.

Examples

Example 1

Olivia is a California resident who agrees to work in China for one year. She returns to California after her employment contract expires. After staying in California for three months, she signs another contract with the same employer to return to China and work there for another year. Should Olivia file a resident or nonresident return?

Answer

Unfortunately for Olivia, she cannot be considered a nonresident under the safe harbor rule because she has not met the condition that requires her to be absent from California for an uninterrupted period of at least 546 consecutive days for employment reasons. Even though she has been absent for a total greater than 546 days, she cannot combine the days from the two separate contracts. Olivia thus remains a California resident and will file a resident return.

Example 2

Frank is a California resident who transfers for a two-year work assignment to his employer's head office in Sweden. While still based in Sweden, Frank returns to California for a three-week vacation. Should Frank file a resident or nonresident return?

Answer

Under the provisions of the safe harbor rule, Frank is a nonresident of California for the two years that he is working in Sweden. His three-week visit to California does not disqualify him because the visit

was less than 45 days and is therefore considered temporary. Therefore, Frank should file a nonresident return.

Example 3

Krystal and Bob are married and are California residents. Krystal agrees to work in Qatar for 22 months under an employment contract. Her family remains in Pleasanton, California. At the midpoint of her contract, she returns to visit her family in Pleasanton for a month. How should Krystal and Bob file their California tax return?

Answer

Thanks to the safe harbor rule, Krystal can be considered a nonresident during her absence. Her month-long visit to California is considered temporary because it did not exceed the 45-day threshold. Bob is still considered a resident of California because he remains in California during the period that Krystal works in Qatar. As is the case for all married couples, Krystal and Bob have two options for filing their California tax return:

- For a joint return, they would use Form 540NR, the nonresident return.
- For a separate return, Krystal would use Form 540NR, and Bob would use Form 540.

Knowledge Check

Test Your Knowledge!

Which of the following meets the requirements for the 546 consecutive day safe harbor rule that allows a California resident to be considered a nonresident?

Maya lives in California but spends 550 days in Japan taking care of her sick mother.

This answer is incorrect. The safe harbor rule requires being out of California under an employment contract, not for personal reasons.

Javier lives in California but spends 560 days in Chile working at the office of his employer's subsidiary.

Correct. Being out of California for over 546 days under an employment contract allows Javier to be considered a nonresident under the safe harbor rule.

Anne lives in California but spends 600 days in France taking painting classes and visiting museums.

This answer is incorrect. Anne's extended time in France is not due to an employment contract, which is required for the safe harbor rule.

Ryan lives in California but spends 500 days in Australia working remotely for his California employer.

This answer is incorrect. The safe harbor rule requires being physically outside of California for 546+ days, not just working remotely.

Military Service Members

California has special rules for determining a military service person’s residency status:

- A military member who leaves California under permanent military orders (a permanent change of station, or PCS) is treated as a nonresident for tax purposes.
- A military member who is stationed in California on PCS orders is a resident, even when sent on temporary duty assignments outside of California.

As with non-military individual taxpayers, California taxes all income while the member is a resident and only California-source income while a nonresident. When there is a resident non-military spouse, that spouse's half of the community income is taxable regardless of its source.

Under the Military Spouses Residency Relief Act (MSRRA), a non-military spouse may be exempt from California taxation. To qualify for this exemption, the taxpayer must meet all of the following requirements:

- must not have been in the military
- must have been legally married to the military member
- must have lived with the military spouse/RDP
- must have had a military spouse with a permanent change of station (PCS) order moving that spouse to California
- must have been domiciled in a state other than California

Taxation of service members is covered by FTB Publication 1032, Tax Information for Military Personnel.

Topic Spotlight: Military Personnel

For service members domiciled outside of California and for their spouses, the service member's military compensation will be excluded from gross income when computing the tax rate on nonmilitary income. Requirements for military service members domiciled in California remain unchanged. Military service members domiciled in California must include their military pay in total income. In addition, they must include their military pay in California-source income when stationed in California. However, military pay is not California-source income when a service member is permanently stationed outside of California.

Heroes Earnings Assistance and Relief Tax (HEART) Act

California conforms to the federal HEART Act of 2008 that permits the rollover of a federal military death gratuity payment or Service members' Group Life Insurance proceeds into a Roth Individual Retirement Arrangement (IRA) or Coverdell education savings account (ESA) without regard to otherwise applicable contribution limits.

Differential wage payments made on or after January 1, 2009, to members of the uniformed services on active duty for more than 30 days will be treated as compensation for purposes of a retirement plan and IRA contributions. Differential wages are all or part of the wages paid by an employer as if the member were performing service for the employer rather than being on active duty.

Individual Retirement Plan Contributions

California conforms to the federal Heroes Earned Retirement Opportunities Act that allows members of the Armed Forces serving in a combat zone to make contributions to their individual retirement plans even if the compensation on which such contribution is based is excluded from gross income.

Early Distributions Not Subject to Additional Tax

California conforms to the exceptions from the penalty on early withdrawals from retirement plans for qualified distributions made after September 11, 2001, to reservists while serving on active duty for at least 180 days.

Military Spouses Residency Relief Act (MSRRA)

The MSRRA amended the federal Service Members Civil Relief Act. For taxable years beginning on or after January 1, 2009, a nonmilitary spouse of a military service member shall neither lose nor acquire a residence or domicile for tax purposes by being absent from or present in California to be with the service member serving in compliance with military orders if the service member and spouse have the same domicile.

The income of a military service member's nonmilitary spouse for services performed in California is not California-source income subject to state tax if the spouse is in California to be with the service member serving in compliance with military orders, and the service member and spouse have the same domicile in a state other than California.

California also conforms to the Military Family Tax Relief Act to allow the following:

Deduction for Overnight Travel Expenses of National Guard and Reserve Members

Reservists who stay overnight more than 100 miles away from home while in service (e.g., for a drill or meeting) may deduct unreimbursed travel expenses (transportation, meals, and lodging).

Exclusion of Gain on Sale of a Principal Residence

A taxpayer on qualified official extended duty in the U.S. Armed, Uniformed, or Foreign Services may suspend, for up to 10 years of such duty time, the running of the five-year ownership-and-use period before the sale of a residence. This applies when the duty station is at least 50 miles from the residence—or while the person is residing under orders in government housing—for a period of more than 90 days or for an indefinite period.

Exclusion from Gross Income of Certain Federal Death Gratuity Payments

A federal death gratuity payment to a survivor of a member of the Armed Forces is excludable from gross income.

Combat Zone Extensions Expanded to Contingency Operations

The various extensions granted to combat zone participants to file tax returns or pay taxes apply to those serving in Contingency Operations, as designated by the Secretary of Defense.

United States Government Officials

The California Code provides a special rule for certain U.S. government officials and their spouses. If such individuals have a California domicile, their absences from the state are considered temporary or transitory. Thus, they remain California residents for taxation purposes.

This rule applies to the following persons:

- any elected U.S. official
- anyone on the staff of a member of the U.S. Congress
- any presidential appointee, subject to Senate confirmation, other than military and foreign service career appointees

Summary

The matter of determining residency status can be quite involved. Depending on a given taxpayer's situation, he or she may be considered a resident, nonresident, or part-year resident. The tax treatment differs for each of these categories, and although the safe harbor rule and nine-month rule help to provide clarification, the facts and circumstances of each case must always be taken into consideration when determining California residency status.

More specifically, you have seen issues and specific examples related to the following:

- a person's status as a California resident, part-year resident, and nonresident
- the relationship between a person's domicile and residency
- the residency status issues for taxpayers who move into and out of California during the tax year
- certain situations encountered by military service members
- special rules for U.S. government officials' residency status

Key points to remember:

- **Resident vs. nonresident definitions**: A California resident is someone present in CA for other than a temporary stay or someone domiciled in CA but temporarily absent. A nonresident is domiciled outside CA, maintains a permanent residence there, and does not engage in activities beyond a typical visitor.
- **Temporary vs. transitory purpose of stays**: If someone is in CA for 6 months or less for vacation, completing a transaction, etc., it is considered temporary/transitory, and they are a nonresident. If they are in CA for retirement, recovery from illness, an indefinite work assignment, etc., their purpose is not temporary/transitory, and they are a resident.

- **Domicile vs. residence difference**: Domicile is the place someone intends to return to and make their permanent home. Residence is any dwelling place including temporary lodging. Domicile implies intent to remain permanently.
- **Safe harbor**: The 546-day rule says someone domiciled in CA but outside the state for 546+ consecutive days under an employment contract is considered a nonresident, with certain exceptions.
- **Military spouse and government exemptions**: Military spouses and some government officials keep their prior home state's residency despite absences from that state.
- **Closest connections test for ambiguous situations**: Factors like driver's license, vehicle registration, voter registration, etc. are used to determine residency when facts are unclear. The strength, not just the number, of connections is considered.

Chapter 4. Filing Status

Introduction

Next, a tax preparer must select the correct filing status for the taxpayer. A taxpayer's California filing status is, in most cases, the same as his or her federal status. However, the exceptions to this guideline are important. This chapter explains the rules for selecting the correct filing status from the following:

- registered domestic partners (RDPs)/married filing jointly (MFJ)
- RDPs/married filing separately (MFS)
- head of household (HOH)
- qualifying widower (QW), also referred to as surviving spouse (SS)

The residency and status determinations must be accomplished early in the tax preparation process, as they drive much of the additional analysis required in the tax preparation process. For married or separated persons, there are additional issues related to income and property ownership and the types of relief available when one person's joint filing harms the other by creating unexpected tax liabilities.

Chapter Objectives

After completing this chapter, you will be able to:

- identify the various tax filing statuses provided by California law and selection of status based on individual circumstances
- calculate income for each taxpayer based on filing status and community property rules
- recall details that registered domestic partners must consider when filing a tax return in California

Filing Status Options

As with residency, a taxpayer's filing status determines many aspects of his or her tax obligations. A taxpayer will have a filing status of single, married filing jointly (MFJ), married filing separately (MFS), head of household (HOH), or qualifying widower. For purposes of California tax law, registered domestic partners (RDPs) are treated the same as married couples.

Single

This status applies if the taxpayer was not married or in a registered domestic partnership, he or she divorced or became legally separated, or if he or she did not remarry or enter into another RDP during the tax year.

Married Filing Jointly

This status applies to a taxpayer married or in a registered domestic partnership (RDP) regardless of whether the partners lived together, one of the two spouses died during the year (and the surviving spouse did not remarry), and if the spouse died in the filing year before the current tax year.

California treats RDPs as spouses for tax purposes. The federal government does not recognize the registered domestic partnership and requires a marriage (rather than a registered partnership) for a taxpayer to claim the self-employed health insurance deduction on his or her partner.

RDP or Married Filing Separately

California requires RDPs to file as MFJ or MFS. For California tax purposes, references to a spouse, wife, or husband also include a California RDP (which can stand for "registered domestic partnership" and "registered domestic partner"). RDPs have the same legal rights and responsibilities as married couples. If a taxpayer has entered into an RDP in another state, the partnership will be recognized by California as long as the legal union is substantially equivalent to such a union in California.

It should be noted that the taxpayer may not claim a federal personal exemption credit for his or her spouse in California (the Tax Cuts and Jobs Act did away with federal personal exemptions altogether). The taxpayer may, however, be able to file as HOH if a qualifying child has lived with him and apart from the spouse or RDP during the entire last six months of the tax year.

Relationship Between Federal and California Filing Status

A taxpayer's California filing status is usually the same as his or her federal filing status. However, federal law recognizes legal marriages but not registered domestic partnerships. As noted previously, California recognizes both types of unions and treats them the same.

The exceptions to using the same filing status for both federal and California tax returns are as follows:

- **Exception**: The taxpayer is in an RDP:
  - Even if the filing status "Single" is used for federal purposes, one of the married statuses—MFJ or MFS—must be used for California purposes.
  - If HOH filing status is used for the federal return, the HOH status can be used in California only if the taxpayer can legitimately claim not to be married or in an RDP.
- **Exception**: The taxpayer or spouse was a U.S. military member on active duty during the year.
- **Exception**: The taxpayer was a nonresident and had no California-source income for the entire year.
- **Exception**: A military member who is married and on active duty may be able to file using MFS in California even if the MFJ status is used on the federal return.

California Non-Conformity

General rule: California filing status is the same as federal filing status.

California exception: The federal government recognizes same-sex marriage and no longer recognizes registered domestic partnerships. Both statuses are recognized in California, and married taxpayers can select MFJ or MFS filing status even if they do not file jointly for federal purposes.

Topic Spotlight: Registered Domestic Partners

A domestic partnership is established in California when both persons file a Declaration of Domestic Partnership with the California Secretary of State, and at the time of filing, either both persons are members of the same sex and meet the eligibility criteria under Title II of the Social Security Act as defined in 42 U.S.C. §402(a) for old-age insurance benefits or Title XVI of the Social Security Act as defined in 42 U.S.C. §1381 for aged individuals:

- Both persons have a common residence.
- Neither person is married to someone else or is a member of another domestic partnership with someone else that has not been terminated, dissolved, or adjudged a nullity.
- The two persons are not related by blood in a way that would prevent them from being married to each other in California.
- Both persons are at least 18 years of age.
- Both persons are capable of consenting to the domestic partnership.

The definition of "common residence" means that both domestic partners share the same residence. It is not necessary that the legal right to possess the common residence be in both of their names. Two people have a common residence, even if one or both have additional residences. Domestic partners do not cease to have a common residence if one leaves the common residence but intends to return.

In general, California affords the same rights and responsibilities to Registered Domestic Partners (RDPs) that previously were available only to married individuals. For California tax purposes, the same long-standing rules applicable to married individuals (relating to filing status, community property income, etc.) now apply to RDPs. However, because the federal government does not recognize domestic partners as married individuals for federal tax purposes, RDPs shall continue to file as unmarried individuals on their federal tax returns.

Community Property Rules and RDPs

In a May 5, 2010, Chief Counsel Advice (CCA) memorandum, the IRS stated that California RDPs should report one-half of their community income on their federal income tax return unless the RDPs previously executed an agreement opting out of community property treatment. The CCA only addresses the treatment of community income of RDPs; it does not change the RDP's federal filing status. For federal purposes, an RDP shall continue to use the single or head of household filing status.

Various RDP adjustments may be required for California taxpayers on their California tax return because the filing status of an RDP for California purposes is not the same as the filing status that the RDP uses for federal purposes. Under California law, RDPs must file their California income tax returns using either the married/RDP filing jointly or married/RDP filing separately filing status. RDPs are not allowed to use a married filing status on their federal tax returns. Frequently, the dollar limits for a single taxpayer and a married couple are the same, and the dollar limit for a married person filing separately is one-half the

amount for a single person or a married couple. To apply the correct dollar limits on the California tax return, an RDP might be required to reduce the amount of a deduction reflected on a federal tax return.

Another category of adjustment occurs when the substantive rule for a transaction is different for a married person. For example, no gain or loss is recognized when spouses transfer property among themselves. Since an RDP is treated as a spouse for California purposes, no gain or loss is recognized for California purposes when one RDP transfers property to his or her domestic partner. However, this transfer is not likely to receive equal treatment for federal tax purposes, and, as such, gain or loss may be recognized for federal purposes.

RDP adjustments include, but are not limited to, the following:

- division of community property
- capital losses
- transactions between RDPs
- sale of a residence
- dependent care assistance
- investment interest
- qualified residence acquisition loan and equity loan interest
- expense depreciation property limitations
- Individual Retirement Account
- education loan interest
- rental real estate passive loss
- rollover of publicly traded securities gains into specialized small business investment companies
- charitable contributions with your standard deduction

Head of Household

Specific requirements for qualifying as HOH are set forth in FTB Publication 1540, California Head of Household Filing Status. Applicable income tax rates are lower for taxpayers with this status. For the most part, the status pertains to taxpayers—single, married but living apart, in an RDP but living apart—when that taxpayer has paid more than one-half the cost of domestic upkeep for the tax year. HOH status is also appropriate for the taxpayer who meets all four of the following requirements as of December 31 of the tax year:

- The taxpayer was not considered married or in a registered domestic partnership.
- The taxpayer has had a qualifying child or relative living with him/her for more than 183 days in the year.
- The taxpayer has paid more than half the cost of maintaining the home for the tax year.
- The taxpayer was a U.S. citizen or legal resident for the whole year.

The taxpayer must include Form FTB 3532, Head of Household Filing Status Schedule, or the FTB will deny HOH status. This form indicates how the taxpayer has determined HOH status is allowable.

Qualifying Widow(er)/Surviving Spouse (SS)

This status may be used for two years after the year of the spouse’s death as long as certain qualifications are met.

The following is based on an example provided by the FTB, showing the five required factors being present for purposes of the surviving taxpayer's filing status:

1. The taxpayer's spouse or RDP died in 2022 or 2023, and the taxpayer did not remarry or enter into another registered domestic partnership in 2024.
2. The taxpayer has either a child, stepchild, foster child, or adopted child that he or she claimed as a dependent.
3. The child lived in the home for all of 2024 (temporary absences for things like vacation or school count as time lived in the home).
4. The taxpayer paid over half the cost of keeping up the home for the child.
5. The taxpayer could have filed a joint return with his or her spouse/RDP in the year of death, even if the taxpayer did not actually do so.

The SS filing status may be used for two years after the year of the spouse's death, thereby allowing the survivor to benefit from joint return rates during that time.

Residency and Identification of California-Source Income

In the materials covering California residency, the issue of income sourcing was mentioned several times. And as noted above, a person's residency status and filing status drive the determination of the types and amounts of income that are taxable by California and whether a California return must be filed at all.

FTB Forms – 540, 540 2EZ, 540NR

The table below summarizes California's personal income tax form requirements based on the taxpayer's residency status. Notice the references in the middle column to "income from California sources."

Residency Status	Taxed by California	Tax Form
Resident	All income from all sources	Form 540 or 540 2EZ
Nonresident	Income from California sources	Form 540NR
Part-year resident	Income from California sources and income while a resident of California	Form 540

For a (full year) resident of California, all income from all sources is taxed. For a part-year resident, California will tax income from all sources earned only during the part of the year the taxpayer is a resident of the state, but only income from California sources during the part of the year the taxpayer is a nonresident. A (full-year) nonresident is subject to California tax only on income from California sources.

Basic Principle – Time of Residency

During the portion of the year that a person is a **California resident**, California taxes **all** of his or her income.

During the portion of the year that a person is a **nonresident of California**, California taxes only **the California-source** income.

As you will continue to see throughout this course, identifying California-taxable income is crucial for many reasons.

First, though, it is important to understand how ownership of assets and attribution of income apply to married and divorced persons. If two spouses file jointly, the implications of community versus separate property are not as important. However, for spouses filing separately, such a determination is key. The tax preparer must know which income is attributable to each person and consider this information in conjunction with each spouse's residency status.

Community Property

The family code provisions of nine states declare that they are community property states: California, Nevada, Texas, Arizona, Idaho, Louisiana, New Mexico, Washington, and Wisconsin. Alaska is the only state to allow the couple to elect community or separate property status. When spouses in a community property state do not have an agreement contradicting the marital property treatment rules, income is treated as community property. The income of both spouses is aggregated and treated as though half belongs to each spouse. The community income, deductions, etc., must be split equally between the two spouses.

This community property status applies to the income of a married couple, anything purchased during the marriage by either spouse (or RDP), and (generally) income received during separation if there is an intention to resume the marriage. If the spouses divorce or separate without an intention to revive the marital relationship, the post-separation earnings of each person are that person's separate property.

When the Law of Community Property "Begins and Ends"

Assets owned by one spouse before the marriage are considered that spouse's separate property. The income derived from these assets during the marriage is community property. Thus, California community property rules "begin" when two people enter into a marriage or RDP and "end" if and when all community assets have been divided.

When one of the spouses dies and has a valid "last will and testament" (a.k.a. "a will"), his or her half of the community property and his or her separate property will be transferred to his or her heirs according to the terms of the will. When a spouse dies intestate (i.e., without a will), the laws of intestacy dictate the disposition of his or her half of the community property. The decedent's half may or may not go to the surviving spouse, depending on how the specific intestacy laws apply to the decedent's situation with respect to surviving relatives.

Commingled Property

In many marriages or RDPs, especially those of longer duration, it can be challenging to identify each spouse's separate property. It is common for a couple to commingle community and separate property over time. When such assets are mixed, it can be difficult to determine the proper disposition of property in a divorce.

The property acquired by the couple during the marriage will be treated upon divorce as either community property or separate property, depending on a number of factors. This characterization can be complicated, but the general rule is that all of either spouse's earnings and accumulations from the date of marriage to the date of legal separation are community property. As noted above, separate property includes property either spouse obtained prior to getting married, gifts and inheritances during the marriage, or property acquired after legal separation.

In a divorce, the court will presume that property acquired during a marriage is community property. Only if one spouse can trace such property to a separate asset will the court treat such an asset as separate property. Direct tracing can be accomplished by providing bank statements from a separate property bank account to show that separate property funds were used to purchase an asset (like a car) during the marriage.

Prenuptial Agreements

Prenuptial agreements are contracts between two spouses or RDPs. Such agreements often dictate what happens to separate property in a divorce. Whether a specific provision applies to a California or IRS tax situation depends on the legality of that provision.

Separate Property

California treats the following types of property as separate property:

- anything owned by either spouse before the marriage
- an inheritance received by only one spouse
- a gift received by only one spouse
- any income or property acquired after the separation date (in a divorce)
- rents or profits that one spouse earned from his or her own separate property (even if the income was earned during the marriage)
- any property purchased by one spouse with that spouse's separate property

Income from Community Property

For the most part, unless the spouses have agreed otherwise, the income from community property belongs to the "community"—to the spouses or RDPs. If they file separate returns, they must split this income equally. However, if there is a credit applicable to a dependent who is supported by money from

the marriage, either spouse or RDP may claim the credit in the case of their filing separate returns. Most credits cannot usually be split.

Complicating matters further, California and federal tax rules are different in how community property laws apply when one spouse is a nonresident alien. For purposes of this course, it is important to recognize when this issue is present in a client's situation so that the appropriate additional analysis can be conducted. The specifics of such analysis are beyond the scope of this course.

California Non-Conformity

Federal law: Community property rules do not usually apply.

California law: The resident spouse is liable for one-half of the nonresident spouse's income.

Knowledge Check

Test Your Knowledge!

How does California treat community property income when only one spouse is a resident and the other is a nonresident?

All community income is taxed by California.

This answer is incorrect. Only the resident spouse's share of community income is taxed by California.

Only the nonresident spouse's share of community income is taxed.

This answer is incorrect. The nonresident spouse's share of community income is not taxed by California.

All community income is exempt from California tax.

This answer is incorrect. At least a portion of community income is taxable by California in this situation.

The resident spouse's share of community income is taxed by California.

Correct. When one spouse is a nonresident, California only taxes the resident spouse's share of community income.

Common Law Marriage

Another question that can come up is: Are two people actually married?

Some states recognize less formal arrangements as marriages, namely, common law marriages. A common law marriage is one that is created by living together a certain amount of time and meeting other criteria that indicate a couple intends to be treated as married. There are only a few states that recognize such couples as legally married:

- Alabama

- Colorado
- Iowa
- Kansas
- Montana
- South Carolina
- Texas
- Utah
- Washington, DC

Note that California is not one of these states. In order for a couple to be treated as married for California tax purposes, they must form a registered domestic partnership or obtain a marriage license and exchange vows in a civil or religious ceremony. The federal government recognizes common law marriages for tax purposes only if common law marriage is recognized in the state where the taxpayers currently live or in the state where they established their marriage (i.e., in one of the states listed above).

California Non-Conformity

California: generally follows community property rules

Federal: does not usually recognize community property rules

Innocent and Injured Spouse – Joint Return

Spouses filing a joint tax return are both responsible for paying any California income taxes, penalties, and interest. However, California and the federal government provide for relief for an innocent joint filer. A taxpayer who meets all three of the following requirements may qualify for relief in California:

- The taxpayer filed a joint tax return.
- The spouse or RDP created the tax debt.
- Given the facts and circumstances, it would be unfair to hold the spouse not creating the tax debt liable for that tax debt.

One type of relief is called "equitable relief" (the term "equitable" means "fair"). The FTB will consider the facts and circumstances to determine whether holding the spouse who did not cause the tax debt liable for that tax debt. Examples of facts and circumstances historically considered by the FTB include the following:

- whether the innocent spouse has been abused by the other spouse during the marriage or RDP
- whether the innocent spouse knew or should have known when signing the tax return that the tax was understated
- whether the innocent spouse's financial situation makes that person unable to pay the tax debt
- whether a divorce decree identifies the non-innocent spouse as being legally responsible for the tax debt
- whether the innocent spouse received a significant benefit from the unpaid tax
- whether the innocent spouse was compliant with tax law for the year(s) after the tax year for which relief is being requested

- whether the IRS has given innocent spouse relief for federal tax debt generated by the same underlying facts and circumstances as the California tax debt (The taxpayer must provide the FTB with a copy of the IRS final determination letter.)

When a taxpayer using the MFS filing status files a separate return and omits community income, undergoes an audit, and, as a result, is assessed increased tax, there are conditions that might justify relief. This community income relief is sometimes allowed if the taxpayer meets all four of the following requirements:

- They did not file a joint tax return.
- They omitted a community income item on the separate tax return.
- They did not know of the community income item.
- They can prove that the unreported income was the spouse's or RDP's responsibility.

Additionally, a divorce decree or termination of a registered domestic partnership may qualify a person for relief if the court order includes all three of the following pieces of information:

- specific reference to the amount of California state income tax due
- specific reference to each tax year for which relief is granted
- the amount of unpaid tax due that each taxpayer is required to pay

If joint gross income exceeds $150,000 or the taxpayer owes more than $7,500, the taxpayer must request a Tax Revision Clearance Certificate from the FTB to be used by the divorce court in making sure that each spouse pays his or her fair share of any tax debt. This letter must generally be obtained before the divorce court issues a final decree because the divorce court cannot release a taxpayer from liability for tax debt on earned income or provide relief for taxes already paid.

Once the divorce court issues its final order, the taxpayer must send the FTB a copy of the decree.

In order to request relief, the taxpayer must send the FTB an Innocent Joint Filer Relief Request, FTB Form 705. Additionally, the FTB requires documentation explaining why relief should be granted, copies of state and federal tax returns for the tax years at issue, a copy of any IRS letters related to requests for relief from federal tax liability, and a complete copy of the divorce decree or termination of RDP. The FTB is required to notify the other spouse or ex-spouse to ask for documentation and to provide notification of the relief request so that he or she has an opportunity to appeal the FTB determination.

Innocent and Injured Spouse – Separate Returns

Innocent spouse relief requirements for separate filers resemble but are not exactly the same as those of a joint filer. In order for an innocent spouse who files separately to exclude community income, all four of the following requirements must be met:

- The couple did not file a joint tax return.
- The innocent spouse did not include an item of community income on a separate tax return for that tax year.
- The innocent spouse did not know of that community income item.
- The innocent spouse can prove that the unreported income was the responsibility of the other person.

As you can see, the issues of residency, community property, and filing status are inextricably linked. This linkage must be kept in mind throughout the analysis of a client's state tax determination and filing. As you will see in the next section, all three factors are relevant in determining whether a California taxpayer has exceeded California income thresholds that require filing at all. Remember from earlier sections of this course that California residents are subject to California tax on all California-source income regardless of residency status. A resident or part-year resident is also subject to California tax on non-California source income that is earned during that taxpayer's period of California residency. In the case of a nonresident spouse with no California-source income, remember that additional analysis will be required to determine which portions of the nonresident spouse's income should be treated as the resident spouse's community property and, therefore, subject to California income taxation.

Summary

You have now seen that, as with residency status, a taxpayer's filing status affects not only whether a taxpayer must file in California and pay California taxes at all but also how much tax must be paid. Additionally, income sourcing is required when any of it is earned outside of California during the time a taxpayer is a nonresident. More specifically, you have now reviewed the following topics:

- basic rules for the different filing statuses: single, MFS, MFJ, HOH, QW/SS
- circumstances justifying a California filing status that is not the same as the taxpayer's federal filing status
- community property rules and issues
- innocent and injured spouse relief

Key points to remember include the following:

• **Filing status**: Each status has specific requirements related to marital status. Single taxpayers cannot be married or in a registered domestic partnership (RDP). Married filing jointly taxpayers must be married or RDPs. Married filing separately also applies to RDPs. Head of household taxpayers must pay over half the cost of keeping up a home for a qualifying person like a child. Qualifying widower status applies for two years after the spouse's death if other rules are met.

• **Impact of residency on filing status**: A nonresident with no CA source income does not have to file a CA return even if married. Part-year residents would likely use married statuses for the portion of the year they are CA residents.

• **Community property income**: In community property states like CA, a married couple's or RDP's income is combined and split equally regardless of who earned it. Exceptions apply for separate property.

• **Innocent spouse relief**: A spouse who did not contribute to a tax underpayment may be relieved of joint liability if certain conditions are met. Relief is harder to obtain for separate filers.

• **California vs. federal status**: RDPs must use married status in CA even if single federally. Status also differs if a military member or nonresident with no CA income.

Chapter 5. California and Federal Income

Introduction

California gross income consists of all non-exempt income received from all sources in the form of money, goods, property, or services. California adjusted gross income (AGI) consists of a taxpayer's federal adjusted gross income from all sources, reduced or increased by California adjustments. California law requires every individual with California gross income or California adjusted gross income above certain thresholds, based on their filing status, age, and number of dependents, to file an income tax return.

This chapter brings together the rules about residency, filing status, and California income. Then, you will learn about the rules for sourcing certain types of income to California.

Chapter Objectives

After successfully completing this chapter, you will be able to:

- identify differences between federal and California tax law on various items of income, deductions, and tax credits
- recall filing thresholds based on federal and state income levels

California and Federal Income

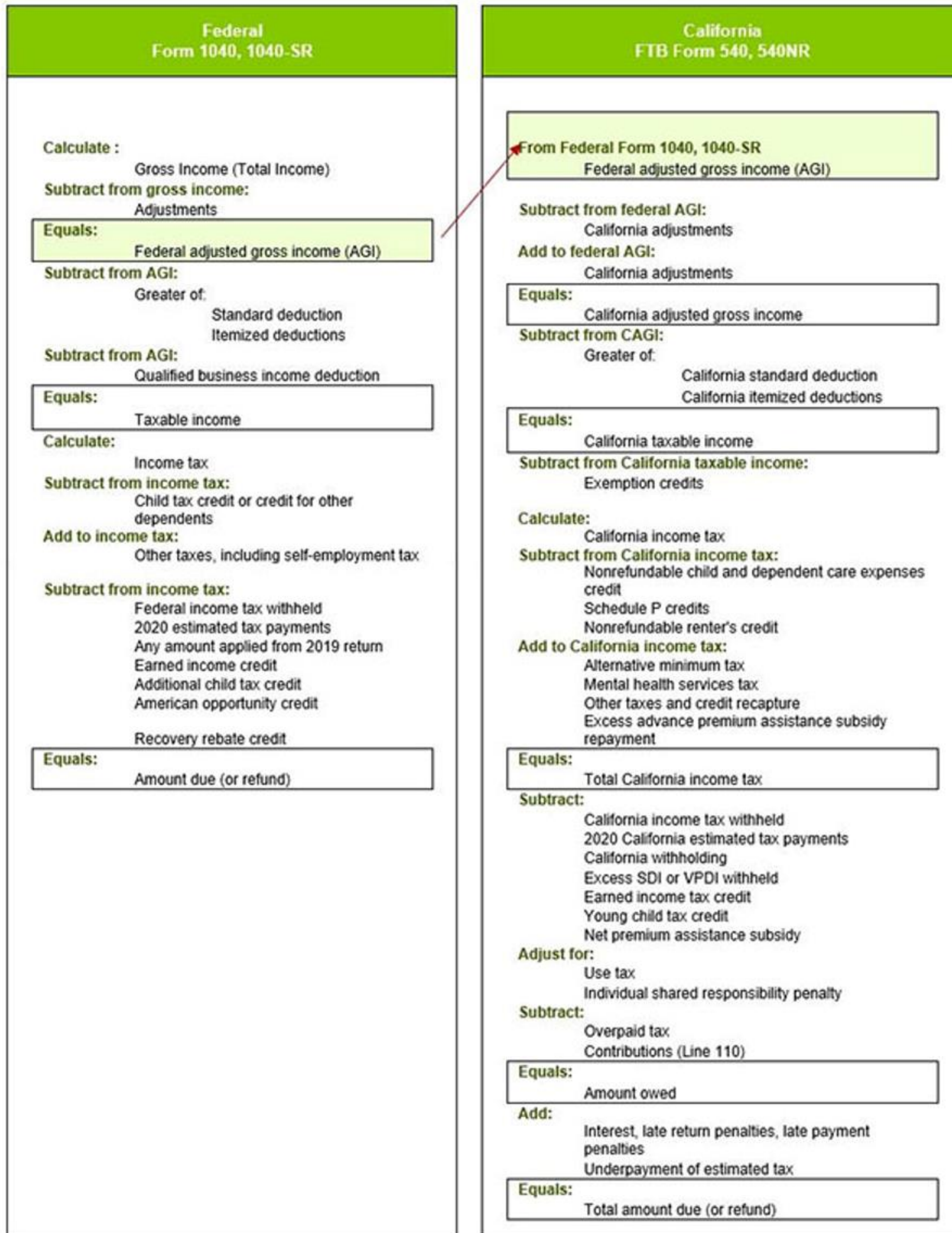
Typical sources of income in California are the same as those common for federal tax purposes. The major types of income and sources, as worded on FTB Form 540, are as follows:

- wages, salaries, tips, etc.
- taxable interest
- ordinary dividends
- IRA distributions
- pensions and annuities
- Social Security benefits
- capital gain (loss)
- taxable refunds, credits, or offsets of state and local income taxes
- alimony received
- business income (loss)
- other gains (losses)
- rental real estate, royalties, partnerships, S corporations, trusts, etc.
- farm income (loss)
- unemployment compensation
- other income:
    - California lottery winnings
    - disaster loss deduction
    - federal net operating loss (NOL)

- NOL deduction from FTB 3805V
- student loan discharged due to the closure of a for-profit school

The basic steps for calculating income tax for both federal and state purposes are similar, with the starting point for the California process being the federal AGI. The California AGI is computed by taking the federal AGI and reducing it or increasing it by California income adjustments. These adjustments are made using Schedule CA (California Adjustments – Residents). Income and itemized deductions are adjusted based on California rules in order to arrive at California AGI.

The information flow means that a person's federal tax return must be completed before the California tax return. See the diagram below.



Federal Tax Return

As you can see from the diagram above, the steps and the flow from federal to California are as follows:

1. The tax preparer starts with federal gross income and subtracts adjustments to get adjusted gross income.
2. Next, the preparer subtracts either the standard deduction or the total of itemized deductions.
3. Then, the preparer subtracts the qualified business income deduction (QBID) to arrive at taxable income.
4. This figure is used to calculate income tax—from the tax tables or from applicable tax formulas.
5. The income tax figure is reduced by certain credits (child tax credit or credit for other dependents).
6. Certain employment-related taxes are added to the income tax figure—namely, a self-employed person's portion of employment tax.
7. Previous payments of income tax are subtracted, as are amounts withheld.
8. Certain credits are subtracted, some of which are new for 2020.
9. The final figure is the amount due (or the refund due to the taxpayer).

California Tax Return

To complete the California tax return, the preparer should start with the figure from Step 1 above.

1. California adjustments are added and subtracted as appropriate. This calculation yields the California-adjusted gross income. When you are reviewing the tax forms, you should note that there is a space on the California return to indicate California wages. This figure is already included in federal income—the California adjustments include anything necessary to remove income that's not taxable by California.
2. California adjusted gross income is reduced by either the standard deduction or by the sum of California itemized deductions (whichever is greater). This calculation yields the taxpayer's California taxable income.
3. As with federal, income tax is calculated—this time using the California tax tables and/or formula.
4. Tax is reduced by any payments already made as well as by tax credits, including credits for contributions to specifically listed California voluntary funds (line 110).
5. Now the preparer has the amount of tax owed.
6. In order to determine how much money to send in, the tax owed should be increased by the amount of any penalties and by any tax underpayments.
7. If the final figure is negative, it indicates the amount due to the taxpayer as a refund.

As we go through these and additional elements of California income taxation, you will see specific areas of non-conformity with federal law.

Federal AGI and California AGI are factors determining whether a taxpayer has a filing requirement.

Income-Based Filing Requirements

An individual taxpayer's California gross income and adjusted gross income are taken into consideration in determining whether a person is required to file a tax return at all. So far, our discussion has been limited to California gross income. California adjusted gross income, which would be gross income less deductions, must also be considered. If the taxpayer exceeds either threshold, he or she must file a tax return.

Income Thresholds

An individual taxpayer's California gross income and adjusted gross income are taken into consideration in determining whether a person is required to file a tax return at all. So far, our discussion has been limited to California gross income. California adjusted gross income, which would be gross income less deductions, must also be considered. If the taxpayer exceeds either threshold, he or she must file a tax return.

Individuals who are deemed residents, part-year residents, or nonresidents with California-source income must generally file a California Resident Income Tax Return Form 540 2EZ, 540, or 540NR if their income exceeds the California gross income or California adjusted gross income thresholds shown in the tables below.

California Gross Income – Filing Thresholds 2023 Tax Year

On 12/31/23, my filing status was:	and on 12/31/23, my age was: (If your 65th birthday is on January 1, 2024, you are considered to be age 65 on December 31, 2023)	0 dependent	1 dependent	2 or more dependents
Single or Head of household	Under 65	21,561	36,428	47,578
	65 or older	28,761	39,911	48,831
Married/RDP filing jointly Married/RDP filing separately (The income of both spouses/RDPs must be combined; both spouses/RDPs may be required to file a tax return even if only one spouse/RDP had income over the amounts listed.)	Under 65 (both spouses/RDPs)	43,127	57,994	69,144
	65 or older (one spouse/RDP)	50,327	61,477	70,397
	65 or older (both spouses/RDPs)	57,527	68,677	77,597
Qualifying surviving spouse/RDP	Under 65	N/A	36,428	47,578
	65 or older	N/A	39,911	48,831

California Adjusted Gross Income – Filing Thresholds 2023 Tax Year

On 12/31/23, my filing status was:	and on 12/31/23, my age was: (If your 65th birthday is on January 1, 2024, you are considered to be age 65 on December 31, 2023)	0 dependent	1 dependent	2 or more dependents
Single or Head of household	Under 65	17,249	32,116	43,266
	65 or older	24,449	35,599	44,519
Married/RDP filing jointly Married/RDP filing separately (The income of both spouses/RDPs must be combined; both spouses/RDPs may be required to file a tax return even if only one spouse/RDP had income over the amounts listed.)	Under 65 (both spouses/RDPs)	34,503	49,370	60,520
	65 or older (one spouse/RDP)	41,703	52,853	61,773
	65 or older (both spouses/RDPs)	48,903	60,053	68,973
Qualifying surviving spouse/RDP	Under 65	N/A	32,116	43,266
	65 or older	N/A	35,599	44,519

Dependents

In some situations, an individual who is a dependent of another taxpayer may need to file a California tax return. The requirement to file depends on earned and unearned income amounts. Earned income is payment (salary, wages, etc.) the individual receives for work actually performed. In contrast, unearned income is that from passive sources—interest, dividends, capital gains, and the like.

California

The general rule is that a taxpayer who can be claimed as a dependent of another must file a California tax return if unearned income is $1,150 or more or if gross income is more than that person's California standard deduction.

Federal

A federal return must be filed by a person who can be claimed as a dependent of another taxpayer if unearned income is over $500 or if gross income is more than the person's federal standard deduction.

Non-Income-Related Filing Requirements

As with the federal return, claiming certain credits and refunds requires filing a return even if income does not exceed the thresholds above. In California, a return must be filed if state income tax has been withheld or if California estimated tax payments have been made. A filing is required to get a refund of these funds.

Additionally, when a California taxpayer files an amended federal return, he or she must file an amended California return within six months of the federal filing if the changes on the federal return increase the amount of California tax due. Schedule X, California Explanation of Amended Return Changes, is the form used by the taxpayer to reconcile corrected or changed information with the originally filed information and to explain the reasons for the differences.

Further, even if the taxpayer's gross income or adjusted gross income is less than the amounts listed in the table, he or she may still have a filing requirement or may find it advantageous to file a return, as explained below.

First, let's consider the different types of income, and while doing so, cover how to identify portions of this income as California-source (or non-California source) income.

Wages

The types of income reachable by California are explained in the pages that follow. There are many areas in which California and federal law are similar, but there are significant differences in how gross income is reduced to adjusted gross income, then to taxable income, then to tax liability. Such adjustments come in the form of deductions and credits, among other things. This section of the course covers income items, highlighting areas of California's non-conformity with federal tax laws. Some areas of non-conformity are found in the treatment of the different types of income, whereas other areas of non-conformity are found in the amounts used in calculating adjustments and the like.

California residency status drives the determination of what proportion of total income is includible for California tax purposes. For California residents? All income from all sources is taxable. For nonresidents or part-year residents? The determination becomes more complex.

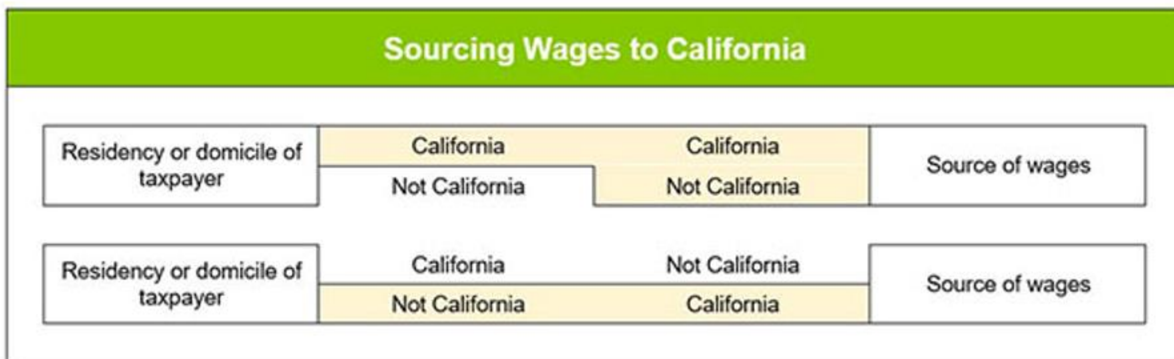
Let's first consider earned income. The IRS defines earned income as "all the taxable income and wages you get from working for someone else, yourself, or from a business or farm you own." Identifying earned versus unearned income is relevant later for determining a taxpayer's eligibility for certain credits and deductions.

Wages, salaries, tips, and bonuses are earned income, which is typically included on a taxpayer's W-2 form supplied by his or her employer. Any such receipts omitted from a W-2 must still be included by the taxpayer in reporting income. Sometimes these receipts are reported to a taxpayer on a Form 1099. Regardless of how the amounts are reported to the taxpayer—and regardless of whether the taxpayer

even receives written notice or summaries of these payments—they must be reported to the federal and California governments.

Sourcing Wages

California residents are taxed by California on their income from all worldwide sources. Part-year residents are taxed on all income from all worldwide sources during the part of the year they are California residents. Nonresidents are taxed only on their California-source income. See the diagram below.



More specific rules and techniques for sourcing these types of earned income (and unearned income, such as interest) are demonstrated in the examples that follow.

Rule

California can tax California residents on their entire taxable worldwide income.

Example

Maya is a California resident for all of the tax year and has income as shown in the table below. How much of this income is taxable by California, and why?

Income Source Determination

All $86,000 of Maya's income is taxable by California. Maya was a resident for the entire year, which means that California can tax all of her income from all sources—wages earned in California, wages earned in Guatemala, and interest from a Florida bank account.

California Resident	
Wages earned in California	$50,000
Wages earned in Guatemala	$35,000
Interest from a Florida bank account	$1,000
Total	$86,000

Non-Resident, California Income

California can tax California nonresidents on their California-source income.

Example

Nils is a resident of Minnesota for all of the tax year and has income as shown in the table below. How much of this income is taxable by California, and why?

Income Source Determination

Only $50,000 of Nils' income is subject to California income taxation. Because Nils was a nonresident for the entire year, only the wages he earned in California are subject to California income tax. His Guatemala wages and his interest income from his Florida bank account are not part of his California gross income.

Nonresident	
Wages earned in California	$50,000
Wages earned in Guatemala	$35,000
Interest from a Florida bank account	$1,000
Total	$86,000

Part-Year Resident, Some California-Source Income

California can tax California part-year residents on all income earned from all sources during California residency and all California-source income earned during California nonresidency.

Example

Gustav is a resident of Alabama from January 1 through June 30 of the tax year, moving to California on July 1 and becoming a California resident at that time. He remains a California resident through the rest of the tax year. Of Gustav's $148,000 in income for the tax year, how much will be treated as California gross income and why?

Income Source Determination

Gustav's income from California will be included in his gross income—both the portion he earned while a nonresident ($35,000) and the portion earned while a resident ($43,000). Additionally, the Alabama wages Gustav earns while a California resident, $20,000, will be counted as part of his California gross income. The $50,000 in Alabama wages Gustav earns while still not a California resident is not included in Gustav's California gross income.

Part-Year Resident	
Alabama wages from January 1 to June 30	$50,000
California wages earned from January 1 to June 30	$35,000
Alabama wages from July 1 to December 31	$20,000
California wages earned from July 1 to December 31	$43,000

Total income	$148,000
Less: non-California income	($50,000)
Equals: California income	$98,000

Community Property and Domicile

Married couples must determine California taxable gross income according to the laws of the state where the spouse earning that part of the income is domiciled. If one or both spouses are domiciled in California for part or all of the tax year, the income earned by that spouse during his or her California domicile time will be treated according to community property rules. More specifically, if the spouse who is acquiring the income is in a community property state, then that spouse's income is treated as community income by California. If the acquiring spouse is domiciled in a separate property state, then California treats the income as separate income.

Example

Anne and Rico are a married couple. Anne is domiciled in and a resident of California. Rico is domiciled in California but is a resident of Oklahoma. Rico travels outside of California from time to time on business. In the current tax year, Rico earns $129,000 while working in California, $26,000 while working in Illinois, and $14,000 while working in New Mexico. Anne earns no income during the tax year. How much of their income will be included in California gross income and why?

Income Source Determination

Because Rico is a resident of California for the entire year, his portion of the couple's income—from all sources—is included in California gross income. The treatment of income is determined according to community property laws (the laws of the state where Rico is domiciled). Rico's income is therefore split evenly between himself and his spouse. Additionally, any of the California-source income is included in California gross income—even Anne's half of the California-source income.

Thus, all of the $129,000 Rico earns in California must be included in California gross income—Rico's half and Anne's half. Only Rico's half of the Illinois wages ($13,000 of the $26,000) and Rico's half of the New Mexico wages ($7,000 of the $14,000) are included in California gross income. Anne's half of the Illinois wages (the other $13,000 of the $26,000) and her half of the New Mexico wages ($7,000 of the $14,000) are not included in California gross income.

California-Source Income			
	Wages	**Rico**	**Anne**
California	$129,000	$64,500	$64,500
Illinois	$26,000	$13,000	$13,000
New Mexico	$14,000	$7,000	$7,000
Total	$169,000	$84,500	$84,500

Effective Tax Rate

To calculate a nonresident or part-year resident's income tax liability, the first step is to determine the effective tax rate the taxpayer would have if all of that taxpayer's income were California-taxable income.

Let's look at an example of this set of calculations by returning to the example involving Gustav from above.

Example

Let's look at an example of this set of calculations by returning to the example involving Gustav from above.

Part-Year Resident	
Alabama wages from January 1 to June 30	$50,000
California wages earned from January 1 to June 30	$35,000
Alabama wages from July 1 to December 31	$20,000
California wages earned from July 1 to December 31	$43,000
Total income	$148,000
Less: non-California income	($50,000)
Equals: California income	$98,000

Step 1

Gustav earned $148,000 total during the tax year. Of this amount, $98,000 is taxable in California.

Step 2

Determine the appropriate tax rate to apply to the $98,000 of California gross income. Consult the appropriate tax rate schedule, in this case, Schedule X, which applies to a taxpayer filing single or MFS.

Use if your filing status is **Single or Married/RDP Filing Separately**		
If the amount on Form 540, line 19 is		Enter on Form 540, line 31
over –	but not over –	
$0	$10,412	$0.00 + 1.00% of the amount over $0
10,412	24,684	104.12 + 2.00% of the amount over 10,412
24,684	38,959	389.56 + 4.00% of the amount over 24,684
38,959	54,081	960.56 + 6.00% of the amount over 38,959
54,081	68,350	1,867.88 + 8.00% of the amount over 54,081
68,350	349,137	3,009.40 + 9.30% of the amount over 68,350
349,137	418,961	29,122.59 + 10.30% of the amount over 349,137
418,961	698,271	36,314.46 + 11.30% of the amount over 418,961
698,271	AND OVER	67,876.49 + 12.30% of the amount over 698,271

Step 3

Let's assume that Gustav's Form 540 Line 31 amount is $98,000. The tax on this $98,000 would be $3,009.40 plus 9.30 percent of the difference between $98,000 and $68,350.
$98,000 – $68,350 = $29,650
9.30% × $29,650 = $2,757.45
$2,757.45 + $3,009.40 = $5,767 total tax

Step 4

Determine Gustav's effective tax rate.
$5,767 ÷ $148,000 = 3.9%

Step 5

Determine Gustav's California income tax. His California gross income is $98,000.
$98,000
× 3.89%
$3,819

Unearned Income of a Child – Kiddie Tax

At the federal and state levels, a child's unearned income may trigger a requirement for the child to file a tax return and, in some instances, to apply a parent's higher tax rate to such income. These rates and requirements apply even when the child can be or is claimed as a dependent of another taxpayer.

For purposes of this tax, a child is anyone aged 19 and under and dependent, full-time students under age 24. The tax does not apply to children within these age ranges if they are married and file joint tax returns.

The "kiddie tax" is intended to keep parents from reducing or avoiding taxes by transferring stock or other investments to their children with lower tax rates. Without the kiddie tax rules, parents would be able to make large gifts of appreciated stock to their children, with their children realizing the gains on this stock and having it taxed at a rate lower than what the parent would be charged.

California's form FTB 3800, Tax Computation for Certain Children With Unearned Income, must be attached to the child's Form 540 or Form 540NR if the child has unearned income over a certain threshold. c

TAXABLE YEAR **2023** **Tax Computation for Certain Children with Unearned Income** CALIFORNIA FORM **3800**

Attach ONLY to the child's Form 540 or Form 540NR.

Child's name as shown on return	Child's SSN or ITIN
Parent's name (first, initial, and last). (Caution: See instructions before completing.)	Parent's SSN or ITIN

Parent's filing status (check one):
☐ Single ☐ Married/RDP filing jointly ☐ Married/RDP filing separately ☐ Head of household ☐ Qualifying surviving spouse/RDP

Part I Child's net unearned income

1	Enter the child's unearned income, such as taxable interest, ordinary dividends, and capital gains. See instructions. If this amount is $2,500 or less, stop here; do not file this form	**1**	00
2	If the child **did not** itemize deductions on Form 540 or Form 540NR, enter $2,500. If the child itemized deductions, see instructions	**2**	00
3	Subtract line 2 from line 1. If zero or less, stop here; do not complete the rest of this form but **attach** it to the child's return	**3**	00
4	Enter the child's **taxable income** from Form 540, line 19 or **total taxable income** from Form 540NR, line 19	**4**	00
5	Net unearned income. Enter the **smaller** of line 3 or line 4. If zero or less, stop here; do not complete the rest of this form but **attach** it to the child's return.	**5**	00

Foreign Employment Income

A U.S. citizen or U.S. resident alien who lives abroad is taxed on worldwide income. A California resident is taxed on all worldwide income, and a nonresident or part-year resident is taxed on some such income, according to the rules previously discussed.

A U.S. employer can be any of the following:

- an individual resident of the United States

- a partnership (if 2/3 or more of the partners are U.S. residents)
- a trust, if all the trustees are residents of the United States
- a corporation organized under the laws of the United States or of any state
- a limited liability company organized under the law of the United States or of any state
- any Indian tribe covered by the United States Code Title 26 §3306

A citizen who works for a U.S. employer and performs services for that employer outside the United States and Canada is liable for California Unemployment Insurance Tax, Employment Training Tax, and State Disability Insurance Tax if either of the following is true:

- The employer's principal place of business in the United States is in California.
- The employer has no place of business in the United States but is one of the following:
  - an individual resident of California
  - a corporation or LLC organized under California laws
  - a partnership or trust and the number of partners or trustees who are California residents is greater than the number of partners or trustees who are residents of any other state

The federal government provides a foreign employment income exclusion and a foreign housing deduction. For federal purposes, the requirements for claiming these benefits are having foreign-earned income and a tax home in a foreign country and being one of the following:

- a U.S. citizen who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year
- a U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect and who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year
- a U.S. citizen or U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months

The foreign income exclusion maximum amount per qualifying person is $120,000 for 2023 and $126,500 for 2024.

In contrast, California does not provide a foreign income exclusion. When such foreign income (and/or foreign housing cost) has been excluded in computing federal AGI, there are adjustments that must be made to include this income for California tax purposes. The only situation in which California would exclude foreign income would be under the safe harbor for being out of state under an employment contract. The FTB established this rule for tax years beginning on or after January 1, 1994.

California Safe Harbor

The safe harbor allows for a taxpayer who is domiciled in California but who is outside California under an employment-related contract for an uninterrupted period of at least 546 consecutive days to be considered a nonresident unless one or both of the following two conditions are met:

- The taxpayer's intangible income exceeds $200,000 in any taxable year during which the employment-related contract is in effect.
- The taxpayer's main purpose for being absent from California is to avoid personal income tax.

A person's spouse or registered domestic partner (RDP) will also be considered a nonresident while accompanying the taxpayer outside California for at least 546 consecutive days. Temporary return visits to

California that do not exceed a total of 45 days during any taxable year covered by the employment contract will not prevent the taxpayer from being able to claim the benefits of the safe harbor rule.

As noted above, this safe harbor does not apply to a person who has intangible income of over $200,000 for an employment-related contract year, or the main purpose of being absent from California is personal income tax avoidance. And spouses or RDPs of persons covered by this safe harbor can also benefit from the rule unless any return visit to the state does not exceed a total of 45 days during the taxable year.

Compensation Paid in Cryptocurrency

Although there are some technological challenges in tracing cryptocurrency transactions, compensation received in this form must also be reported and is also subject to income taxation. Cryptocurrency compensation is treated as ordinary income. Elsewhere, the capital gain and loss treatment is covered.

Covenants Not to Compete

In California, for the taxpayer receiving income from a covenant not to compete, such income is taxable as being California-source if that income is separately identifiable from the sale of other intangible assets. This situation occurs, for example, when a taxpayer sells his portion of a business and receives a separate payment for agreeing not to compete with the buyer of the business.

Native American Earned Income Exemption – California

California does not tax federally recognized tribal members living in California Indian country who earn income from any federally recognized California Indian country. Military compensation is considered income from reservation sources.

Federal law taxes income received by Native Americans from reservation sources.

Native Americans who are domiciled on an Indian reservation and receive military compensation must refigure any AGI percentage calculation(s) by first subtracting military compensation from federal AGI. Enrolled members who receive reservation sourced per capita income must reside in their affiliated tribe's Indian country to qualify for tax-exempt status.

Other Income Items

Unemployment, Paid Family Leave, and Death Benefits

Unemployment Income

Unemployment compensation is taxed by the federal government. It is not taxed by California. When completing the California tax return, the taxpayer subtracts the amount from income to arrive at the properly adjusted figure. That is, when a taxpayer has unemployment compensation reported on a Form

1099, the amount of compensation included in federal AGI should be entered onto the California return as an adjustment.

Paid Family Leave Benefits

Similarly, California does not tax family paid leave (FPL) compensation, while the federal government does. California's FPL rights extend for up to six weeks for individuals who:

- have a new baby, adopt a child, or foster a child
- need to care for a seriously ill spouse, domestic partner, child, parent, sibling, grandparent, grandchild, or parent-in-law

Payments from California's FPL program are reported on the federal return as "Certain Government Payments." Because of this different treatment between California and federal tax rules, a California adjustment will be necessary.

California Non-Conformity

Federal: Unemployment and paid family leave benefits are taxed.

California: Unemployment and paid family leave benefits are not taxed.

Workers Compensation Benefits

Workers' compensation benefits are generally tax-free at the federal and state levels. State law provides a schedule of benefits setting forth who is covered, what is covered, how much is paid, and how payments are made. Workers' compensation helps pay for medical care, lost wages, and other financial harm.

There are some exceptions to this tax-free treatment when the worker also receives Social Security Disability Income (SSDI), but it is technically the SSDI that is reduced, not the workers' compensation. The important point to keep in mind is that although workers' compensation generally is not taxable, pre-injury wages, SSDI payments, retirement payments, and returns to work may affect the overall taxation picture.

Alimony and Family Support Payments

The Tax Cuts and Jobs Act (TCJA) changed federal alimony taxation rules, and California law does not conform to the changes.

For marriage settlement agreements entered into on or before December 31, 2018, the person paying the alimony could take a federal tax deduction, and the recipient would pay the federal income tax.

For marriage settlement agreements signed after December 31, 2018, the alimony payments are made from the payer's after-tax income (i.e., the payer is responsible for the tax), and the recipient owes no federal income tax.

California is different. Alimony payments are still deducted by the payer and taxed to the recipient—the treatment applicable for federal purposes before the TCJA's changes.

California Non-Conformity

California: Alimony is taxed to the recipient spouse, not to the payer.

Federal: Alimony is received tax-free by the recipient because the payer makes the payments in after-tax dollars.

Alimony is spousal maintenance—it is typically paid by the higher-earning spouse to the lower-earning spouse (or on behalf of the lower-earning spouse, for things like utility bills) to cover day-to-day living expenses.

Child support is what is paid by a parent to provide health insurance and other financial support for that parent's children. In California, child support is sometimes called "family support." Child support or family support is neither a deductible expense nor taxable income in the year paid and received.

Other payments from one spouse to the other—for property settlements, retirement benefits from community property, and voluntary payments—are not alimony.

That is, the following payments are not treated as alimony and are therefore treated under different rules:

- child support payments
- property settlement payments
- retirement benefits that are paid because they are part of the couple's community property
- voluntary payments that are made before the divorce agreement requires them to be paid

Interest Income

There are many types of interest income, and the tax treatment by California often differs from the tax treatment by the IRS. These differences require adjustments from federal AGI to be made for California tax purposes.

Both the federal government and the California government exempt interest income on certain bonds:

- U.S. Treasury bills, notes, and bonds
- California bonds
- municipal bonds

California includes certain types of interest income that the federal government excludes from taxable income:

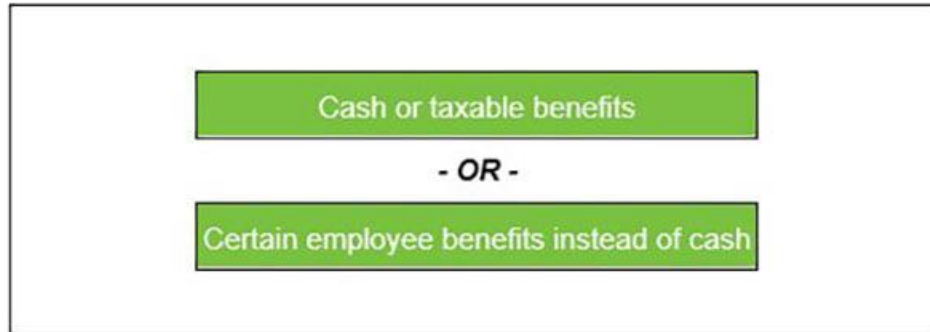
- interest on non-California state or local bonds
- health savings account (HSA) interest (federal tax is deferred)

Children's interest income is generally taxed at both levels, but there are special rules for this type of income, which will be covered elsewhere.

Note that there is a penalty charged on early withdrawal of savings. There are interest penalties that will apply for such withdrawals made while a California resident.

Employee Benefits – Cafeteria Plans

The Internal Revenue Code (IRC) §125 provides rules for cafeteria plans, which provide participants the chance to receive qualified benefits on pre-tax benefits. Cafeteria plans, including flexible spending accounts (FSAs), must give participants a choice:



Providing benefits under such plans offers significant tax savings—unemployment, payroll, and income tax, to name a few. Cafeteria plan benefits must be specifically allowed under IRC §125 in order to be tax-free. See the table below for a list of benefits qualified for federal cafeteria plans along with benefits specifically disallowed. Although deferred compensation arrangements are generally not includible in cafeteria plans, 401(k) plans are an exception.

Qualified Benefits	Benefits Not Allowed
Accident and health benefits	Archer medical savings accounts
Adoption assistance	Athletic facilities
Dependent care assistance	De minimis benefits
Group-term life insurance coverage	Educational assistance
Health savings accounts	Employee discounts
	Employer-provided cell phones
	Lodging on business premises
	Meals
	No-additional-cost services
	Retirement planning services
	Transportation (commuting) benefits
	Tuition reduction
	Working condition benefits
	Scholarships or fellowships

Accident and Health Benefits

Federal plans can include certain accident and health benefits but not Archer medical savings accounts or long-term care insurance. Benefits taxation under accident and health plans depends in part on who paid the premiums and, in the case of direct reimbursements to the employee, how those payments were made.

When an employee receives income from an employer as a result of sickness or injury, there are certain situations in which the payments are excluded from tax and others in which the payments are included. If payments are received based on an insurance policy, they are excluded if the employee was the one making the premium payments.

When an employee receives sick pay directly from the employer, the income would be included on the employee's W-2 as taxable wages.

Adoption Assistance

Employers may offer an adoption assistance flexible savings account to employees. As with other FSAs, the plan must be made available under a cafeteria plan providing employees with a choice between cash and certain qualified benefits.

California provides an adoption cost credit, so federal exclusions will require an adjustment on the California tax return. If a taxpayer deducts adoption-related expenses on his or her federal return and is going to claim the adoption cost credit on the California return, an adjustment must be made on Form 540 or 540NR.

Dependent Care Assistance

An employer can provide tax-favored dependent care services under a written dependent care assistance program that covers only employees. Services must be for a qualifying person's care and be provided to allow the employee to work. The tests for determining whether care is eligible are the same as those required for claiming the dependent care credit, discussed elsewhere in this course.

An employee can generally exclude up to $5,000 of benefits each year ($2,500 for married employees filing separate returns). The exclusion cannot be more than the earned income of the employee (or of the employee's spouse if that spouse's earned income is lower). Anything above that amount is taxable. An employee's W-2 must show the total amount provided in dependent care assistance.

A plan cannot favor "highly compensated employees." A highly compensated employee is generally considered to be one who is (1) a 5 percent owner at any time during the year or preceding year or (2) received more than $130,000 in pay for the preceding year. However, even an employee who received more than $130,000 in pay for the preceding year can have this factor ignored if he or she was not among the top 20 percent of employees when ranked by pay for the preceding year.

Example

Alpine Shoe Corporation has a cafeteria plan providing employees with the option for dependent care assistance through an FSA. Alpine also has on-site backup care available for occasional use by employees at no cost. Wolfgang, an employee of Alpine, has $4,000 deducted from his pay for the dependent care FSA. Wolfgang also used the on-site care for seven days during the year. The fair market value of this on-site care was $1,400. How much will Alpine need to include onWolfgang's W-2 for dependent care assistance? How much of this assistance is taxable?

Answer

Wolfgang's W-2 should show $5,400 in dependent care assistance. Of this amount, $1,400 is taxable, and applicable taxes should be withheld.

Group-Term Life Insurance Coverage

An employee can exclude from gross income the cost of employer-provided group term life insurance for up to $50,000 worth of coverage. Any cost of insurance coverage above that amount is included in the employee's gross income. To be excludable, the coverage must meet all of the following requirements:

- It provides a general death benefit that is not included in income.
- It is provided to a group of employees.
- It provides an amount of coverage based on a pre-determined formula based on such factors as age, years of service, pay, or position (rather than allowing an employee to select a specific amount of coverage).
- It is provided under a policy directly or indirectly carried by the employer, which is determined according to specific rules provided by statute.

Health Savings Accounts – Federal

Another commonly offered type of FSA is the health savings account (HSA). The employer makes contributions to the employee's (or former employee's) account and cannot later withdraw these amounts. Funds in the account can be used by the employee to pay current or future medical expenses of himself, his spouse, and any qualified dependent(s). The funds cannot be used to cover expenses that are reimbursable by insurance.

To be eligible for coverage, the employee must be covered by a High Deductible Health Plan (HDHP) and not covered by other insurance except by insurance listed under IRC §223(c)(3) or by insurance for accidents, disability, dental care, vision care, long-term care, or some telehealth and remote care plans.

The 2023 requirements for qualifying HDHPs are a deductible of at least $1,500 for self-only coverage ($3,000 for family coverage) and an annual out-of-pocket limit of $7,050 for self-only coverage ($15,000 for family coverage).

Requirements for eligibility for contributing to an HSA are generally that:

- The person cannot be claimed as a dependent on another person's tax return.
- The person cannot participate in a health FSA or health reimbursement arrangement.
- The person cannot be enrolled in Medicare Part A or Medicare Part B.

There is no income limit restricting eligibility or a requirement for the account owner to have earned income in order to contribute to an HSA.

An employer can make an additional $1,000 contribution. Such contributions will be exempt from federal withholding, Social Security tax, Medicare tax, and FUTA.

If an employer's HSA contributions are not comparable for all employees who have comparable coverage during the same period, the employer is liable for a 35 percent excise tax levied on the amount contributed to all employees' HSAs.

For 2024, the minimum annual deductible amounts are $1,600 (self-only coverage) and $3,200 (family coverage), and the maximum annual deductible and other out-of-pocket expense amounts are $8,050 (self-only coverage) and $16,100 (family coverage).

Health Savings Accounts – California

California does not conform to the federal HSA provisions. When a taxpayer deducts HSA contributions on his or her federal return, these deductions must be added back to AGI for the California return (as is any interest earned on the HSA account and deducted for federal purposes).

To the degree health care expenses exceed 7.5 percent of AGI, a deduction may be claimed on the California return.

California Non-Conformity

California: HSA contributions are not deductible.

Federal: HSA contributions and the interest earned on HSA funds are excludable from gross income.

Other Fringe Benefits

There are other fringe benefits for federal and California tax purposes, some of which receive different treatment under the two codes.

Qualified Transportation Benefits

Federal law allows an exclusion from gross income for certain qualified transportation benefits. California allows this benefit for a much broader range of transportation types and does not limit the amount of the monthly exclusion. For example, California excludes subsidized parking, vanpools, commuter buses, taxi-pool subscriptions, transit passes for employees and their dependents, and other ridesharing arrangements.

California Non-Conformity

Federal: limits exclusion on qualified transportation benefits; taxes rideshare reimbursement

California: allows exclusion of ridesharing reimbursement

Meals and Lodging

When meals and lodging are furnished to employees for the convenience of the employer, both federal and California tax rules allow the value to be excluded from gross income. In order to receive this exclusion, the meals must be furnished on the employer's premises, and the employee must be required to accept the lodging on the employer's premises as a condition of employment.

Otherwise, meals and lodging provided to employees are considered wages and, as such, need to be assigned a monetary value. For employees who are covered under a contract of employment or union agreement, the taxable value of meals and lodging should not be less than the estimated value stated in that document. If the cash value is not stated in an employment contract or union agreement, the information supplied by the Employment Development Department (EDD) can be used to determine the value of the meals and/or lodging an employer provides to his or her employees.

There are 32 areas in California for which location-specific per diem rates are specified by the federal government. For travel to areas within California that do not have specified per diem rates, the general per diem rates are used.

For 2022, the general California per-night lodging amount is $96.00 and per-day meals amount is $59.00.

For 2023, these amounts are $98.00 for lodging and $59.00 for meals.

California Per-Diem Amounts – General		
	Meals Per-Diem	Lodging Per-Diem
2023	$59.00	$98.00
2024	$59.00	$107.00

Education Assistance

Education Assistance	Federal	California
Employee educational assistance plans	Excluded	Excluded
Qualified tuition programs	Excluded	Excluded

Employee Educational Assistance Programs

The CARES Act allows an exclusion from federal income of employer-provided educational assistance payments made between March 27, 2020, and before January 1, 2026.

Payments can be used against principal and interest on qualified education loans, and they can be excluded from the recipient's income up to $5,250 per year. For such payments to be excludable, the following requirements must be met:

- payments are made for tuition, fees, books, supplies, equipment
- payments are made for instruction or training that improves or develops the recipient's capabilities

The payments do not have to be for work-related courses or for courses that are part of a degree program. Payments in excess of $5,250 might be deductible if they would otherwise qualify as a working condition fringe benefit—that is, a benefit that would have been deductible as a business expense had the recipient deducted it. If payments in excess of $5,250 do not qualify as working condition fringe benefits, the excess is included in taxable wages.

The recipient cannot use any of the tax-free education expenses paid for by his or her employer as the basis for any other deduction or credit, including the American opportunity credit and lifetime learning credit.

Gifts, Inheritances, Prizes, and Awards

Amounts received by taxpayers in certain gift-like situations may be excludable or partially excludable under federal or California tax law (or both).

Gifts and Inheritances

Gifts are transfers of property made during a donor's life.

An inheritance is received after the donor's death. When a person dies, the property he or she owns at that time forms an estate. Estates have their own system of taxation. A trust is created when a person provides property (trustor) for the benefit of someone else (the beneficiary), and that property (the trust "corpus") is to be managed by a third party (trustee or fiduciary). Trusts also have their own taxation rules. FTB Form 541 is the appropriate form to file for an estate or trust tax return.

Gifts and inheritances are not included in income unless they later produce income. The income on such gifts and inheritances is taxable. Income from gifts and inheritances tend to include some or all of these items:

- **interest income**—earned on various types of accounts (including mortgage escrow), refunds, offsets, credits, and out-of-state municipal bonds
  - federal—The interest amount is treated as income.
  - California—The interest income is included in federal AGI, which is used as a starting point for completing a California return and reporting to California.
- **ordinary dividends**—income paid by a company to owners of its stock
  - federal—Report as ordinary income.
  - California—This ordinary income will be included on the federal return, as noted, and will thereby be reported to California.
  - There is no lower rate for dividend income.

Annual Gift Exclusion; Uniform Lifetime Exclusion

A person can give any person up to a certain amount—the annual gift tax exclusion—without being liable for gift tax. The exclusion applies to each person receiving a gift.

Gift and Estate Tax Exclusions		
Year of Death	**Annual**	**Lifetime**
2014–2017	$14,000	$11,580,000
2018–2021	$15,000	$11,700,000
2022	$16,000	$12,060,000
2023	$17,000	$12,920,000
2024	$18,000	$13,610,000

For tax year 2023 (filing year 2024) a taxpayer can give up to $17,000 to each of an unlimited number of persons.

The uniform lifetime exclusion applies to all gifts made during the taxpayer's lifetime, and it is the amount excluded from estate tax at the taxpayer's death. So, as long as the total of lifetime gifts is below the lifetime exclusion ($12,920,000 for tax year 2023), there will be no gift or estate tax due. California allows the same exclusion.

Scholarship and Fellowship Grants

California law conforms generally with federal law regarding the taxation of scholarships and fellowships. The IRS defines a scholarship as an amount paid to a student (or to the educational institution) for the purpose of study or research. Need-based grants generally receive the same treatment.

Some or all of such payments may be tax-free. They are tax-free to the degree they are received in the form of tuition abatements, or if the recipient:

- is a candidate for a degree at an educational institution with a regular faculty and curriculum and the instruction has a regularly enrolled body of students in attendance at the place where the institution carries on its educational activities
- uses the amount to pay for required tuition and fees, fees for books, supplies, lab equipment, or other similar equipment and services directly tied to the education and not the types of costs a student would incur regardless of his or her educational activities (i.e., the portion of such grants and scholarships used for food, room and board, etc. is not tax-free)

Amounts are also tax-free if they are received for:

- services required by the National Health Services Scholarship Program

- services required by the Armed Forces Health Professions Scholarship and Financial Assistance Program
- a comprehensive student work-learning-service program operated by a work college

More specifically, certain receipts must be included in gross income. Taxable amounts include those received for:

- incidental expenses, such as room and board, travel, and optional equipment
- payments for teaching, research, or other services

One exception to California-federal conformity is with grants paid to low-income persons for building or retrofitting structures in order to increase their energy efficiency. California excludes grants paid to low-income persons for this type of building project. There is no such exception to taxability under federal law.

California Non-Conformity

California: exclusion from gross income for grants to low-income students for building and retrofitting structures to increase energy efficiency

Federal: no such exclusion from gross income

Property Inherited Before 1987

Federal gain or loss may differ from the California gain or loss due to differences in the basis of the property. For property inherited on or after January 1, 1987, the California basis and the federal basis are generally the same. The California basis of property inherited from a decedent is generally the fair market value at the time of death.

Prizes and Awards

California generally matches federal law with respect to prizes and awards.

California specifically lists prizes and awards as being includable in taxable income. There are exceptions—employee achievement awards and awards received in recognition of charitable, scientific, or artistic achievement. Eligibility requires that the winner not have to provide future services or take any action in recipient selection. The award must be transferred by the payer to a charity designated by the recipient.

Reward from a Crime Hotline

The federal government includes rewards from a crime hotline. California excludes such payments. The hotline must be one established by a government agency or nonprofit organization. The exclusion is not available to employees of or sponsors of the hotline organization.

Gambling and Lottery Winnings

Gambling includes such things as lotteries, raffles, racetracks, and casinos. To the extent of gambling winnings, the IRS allows a deduction for expenses and losses incurred.

California and Mega Millions lottery winnings are excluded from California taxable income, but lottery winnings from other states are included in taxable income. If the taxpayer had gambling losses and offset them with California lottery income, he may need to reduce the losses included in federal itemized deductions.

The income will be reflected in the taxpayer's federal AGI. Federal AGI is reported to California.

Knowledge Check

Test Your Knowledge!

How would a California resident treat gambling winnings from Las Vegas casinos for tax purposes?

The winnings are tax-free for both federal and California.

This answer is incorrect. Gambling winnings are taxed federally and by California.

The winnings are taxed federally but exempt in California.

This answer is incorrect. California does not exempt gambling winnings earned in other states.

The winnings are exempt federally but taxed by California.

This answer is incorrect. Gambling winnings are included in federal gross income.

The winnings are taxed for both federal and California purposes.

Correct. As a California resident, all income from all sources is taxable, including gambling winnings earned in Las Vegas which are also taxed federally.

Tax Refunds

California State Income Tax Refund

California state income tax refunds are taxed at the federal level but not the state level. If this refund is included as taxable income for federal purposes, the taxpayer makes an adjustment on the state return to

exclude the refund. However, any interest received on a federal tax refund must be included in gross income for federal and California tax purposes.

Cancellation of Debt Income (CODI)

When debt is written off in part or in full by a lender, an individual borrower may have to report Cancellation of Debt Income (CODI) indicated on an IRS Form 1099-C. The forgiven debt is treated as regular income for tax purposes. If a taxpayer does not pay a lender in full when a loan is due (and in the case of real property, for instance, if the property is sold and the lender cannot be repaid in full), the lender reports the loss to the IRS and to the FTB and sends the taxpayer a 1099-C, indicating the amount of debt canceled.

That is, this amount is taxable unless it corresponds to one of five exceptions provided by the IRC and is incorporated into the California Revenue and Taxation Code:

- The discharge occurred as part of a bankruptcy.
- The discharge occurred when the taxpayer was insolvent.
- The discharge was associated with qualified farm indebtedness.
- The discharge was associated with qualified real property business indebtedness (other than for a C corporation taxpayer).
- The discharge occurred before January 1, 2013, and was qualified principal residence indebtedness.

Between 2014 and 2019, if the taxpayer recognized CODI for federal tax purposes, the amount was deducted for California tax purposes. Whether or not there is relief from California tax on cancellation of debt income depends on the broader facts and circumstances surrounding an individual situation, including the type of debt (recourse or non-recourse) that has been discharged, the forum or situation leading to the discharge (bankruptcy court, insolvency), and possibly the occupation of the debtor (e.g., teachers).

Note

If a debt is canceled in a Title 11 case (i.e., Chapter 11 Bankruptcy), the taxpayer should include IRS Form 982 with both the federal and state tax returns to indicate that the debt has been discharged in bankruptcy.

Mortgage Forgiveness Debt Relief

California does not conform to federal tax treatment for this type of discharge of indebtedness (DOI) income. Under federal law, a taxpayer may exclude from income the discharge of indebtedness from the disposition of a principal residence occurring after December 31, 2017.

Student Loan Discharged Due to Closure of a For-Profit School

California law allows an exclusion for student loan amounts discharged due to the closure of a for-profit school. This exclusion is allowed if the loan is discharged because either:

- The individual successfully argues that the school did something wrong or failed to do something it was required to do.
- The individual could not complete a program of study due to the school's closure.

Additional reasons for exclusions are Brightwood College (attended on or before December 5, 2018) and The Art Institute of California school loan discharges that do not qualify for income exclusion under either of the more general situations described above.

Knowledge Check

Test Your Knowledge!

Which of the following types of income is treated the same way by federal and California tax law?

unemployment benefits

This answer is incorrect. Unemployment income is treated differently under federal and California law.

winnings from the California state lottery

This answer is incorrect. Only federal law taxes California lottery winnings.

stock dividends

Correct. The treatment of dividend income is conformity between federal and California tax law. Dividends are taxed as ordinary income.

capital gains

This answer is incorrect. Capital gains are treated differently for federal versus California tax purposes.

Summary

This chapter covered the major components of gross income like wages, interest, unemployment compensation, and prizes. You learned how to identify California taxable income based on residency status. Key differences between federal and California taxation of income items were detailed, such as for cancellation of debt income and health savings accounts.

Key points to remember include the following:

- **How to start completing the California tax return**: Federal AGI is starting point for California return. the figure for federal AGI must be entered on the CA return and then adjusted.
- **California taxable income**: California taxes residents on worldwide income, nonresidents on California source. Residents owe California tax on all income, while nonresidents owe only on California source income.

- **Unemployment and paid family leave differences between federal and California**: Certain income like unemployment compensation and paid family leave is taxed federally but exempt in California.
- **Community property split of income for married filers**: Income earned by a married person while domiciled in a community property state like CA must be split equally between spouses.
- **California adjustments required:** Foreign earned income and cancellation of debt income excluded federally must often be added back in when calculating California AGI.
- **California-source income**: Determine which income items were derived from CA sources and are therefore taxable to a nonresident.

Chapter 6. Withholding

Introduction

This chapter covers issues related to the different ways taxing authorities get a steady stream of revenue and ensure that appropriate tax is paid. You will learn about withholding from wages, what happens when certain mistakes are made that require a payor to keep extra withholding, the requirements to make estimated tax payments during the year, and various penalties associated with underpayment of tax during the year.

Special attention is paid to household employees and the rules that must be followed by their employers.

Chapter Objectives

After completing this chapter, you will be able to:

- recall tax withholding requirements specific to employment and real estate transactions
- recall estimated tax payment requirements necessary to avoid tax penalties for underpayment

Federal Withholding

California and federal tax are both pay-as-you-go. Rather than the government receiving all of its revenue only once per year, tax obligations and payments are distributed throughout the year. That is, taxes must be paid as income is earned or received during the year—either through withholding or estimated tax payments. It is the recipient's responsibility to have enough tax withheld or to make timely estimated tax payments. In determining the amount and timing of estimated tax payments, the taxpayer must take into consideration taxable income from all sources—salaries, pensions, interest, dividends, self-employment income, capital gains, prizes, and awards, just to name a few. Estimated payments must cover income tax as well as self-employment tax and alternative minimum tax.

Wages

An employer must withhold income and payroll tax from employees' paychecks and remit that payment to the IRS and state taxing agency on their behalf. At the end of the year, the individual taxpayer receives a W-2, Wage and Tax Statement, from his or her employer(s). Required withholding amounts depend on the amount of income earned and on filing status, among other factors. An employee can also request additional percentage amounts to be withheld in order to avoid having too little withheld.

Employer Information for Withholding

When hired, an employee generally completes a Form W-4 and gives it to his or her employer(s). This form tells the employer how much to withhold to cover the employee's income tax liability. In essence, the employee uses this form to control how much federal income tax withholding the employer takes out of the employee's paycheck during the year.

An employee can generally provide an updated W-4 to his or her employer at any time.

If an employee does not supply the employer with a Form W-4, the employer should withhold tax as though the employee is single with no adjustments (unless there is an earlier W-4 on file that does not claim exempt status).

Exemption from Withholding

Form W-4 can also be used to tell an employer not to deduct any federal income tax from wages. To be exempt, an employee must have had no federal income tax liability for the previous year and must expect to have no such liability for the current year. To continue to be exempt, an employee must complete a new W-4 and provide it to his or her employer by February 15 each year.

Backup Withholding

A taxpayer may become subject to backup withholding for failing to:

- fully report all interest and dividend income on a tax return
- provide a correct taxpayer identification number (TIN, EIN, or Social Security number) to the payer
- certify, under penalties of perjury, that he or she is not subject to backup withholding for interest and dividend accounts opened after 1983

Before requiring a payer (employer, bank, etc.) to keep backup withholding, the taxpayer will receive four notices from the IRS over a period of at least 120 days. The final notice tells the taxpayer that he or she is subject to backup withholding and that the IRS will notify payers to start backup withholding.

When this happens, the payer must withhold 24 percent of income in order to ensure the IRS receives the tax due on this income.

Types of Income Subject to Federal Backup Withholding Requirements

Many income types are subject to backup withholding, including:

- interest payments
- dividends
- payment card and third-party network transactions
- rents, profits, royalties, or gains
- gambling winnings
- original issue discount
- certain government payments

Types of Income Not Subject to Federal Backup Withholding Requirements

Other types of income are not subject to federal backup withholding. These include:

- real estate transactions
- foreclosures and abandonments
- canceled debts
- distributions from Archer MSAs
- long-term care benefits
- distributions from retirement accounts
- distributions from an employee stock ownership plan
- unemployment compensation
- state or local income tax refunds
- qualified tuition program earnings

Stopping Backup Withholding

The taxpayer can stop backup withholding by correcting the reason for being subject to backup withholding in the first place. That is, the taxpayer could provide the correct TIN, resolve any underreported income and pay the associated tax, or file missing returns.

Credit for Backup Withholding

The taxpayer can report the federal income tax withheld on his or her return for the year in which the income was received.

Differential Wage Payments

Differential wage payments are payments made to an employee by an employer for any period during which the employee is—for more than 30 days—an active-duty member of the uniformed services and represents all or a portion of the wages the employee would have received from the employer during that period. Such differential wage payments are treated as wages and are reported as wages on the employee's W-2 form. Although such differential wage payments are subject to income tax withholding, they are not subject to FICA or FUTA taxes.

Estimated Tax

Corporations and individuals are required to make estimated tax payments regardless of estimated liability.

Individual taxpayers must make estimated tax payments based on their anticipated income, self-employment, and other taxes related to income that is not subject to withholding at source, such as income from:

- self-employment

- interest
- dividends
- includible alimony
- rent
- gains from the sale of assets
- prizes and awards

If too little tax is withheld or remitted as estimated tax payments, penalties will apply. Even if the taxpayer is due a refund when the return is filed, the taxpayer can still be charged a penalty if estimated tax payments were not made timely throughout the year.

Penalties for Underpayment of Estimated Tax and the Safe Harbor

Individuals are subject to an underpayment penalty unless total withholding and estimated tax payments equal the smaller of:

- 90 percent of the tax ultimately due with the prior year's return (i.e., 90 percent of the tax that is due for the current tax year)
- 100 percent of the tax shown on the prior year's return for adjusted gross income (AGI) of $150,000 and below (joint filers) or $75,000 and below (single filers)
- 110 percent of the tax shown on the previous year's return if the taxpayer's AGI for that year was over $150,000 (joint filers) or $75,000 (single filers)

These calculations can be completed on Form 2210.

Paying Estimated Tax

Taxpayers may choose from the following methods to make their estimated tax payments:

- Credit an overpayment on their 2023 return toward their 2024 estimated tax.
- Send a check or money order with the payment voucher titled "1040-ES Estimated Tax for Individuals."
- Pay electronically using the Electronic Federal Tax Payment System (EFTPS).
- Make an electronic funds withdrawal if e-filing Form 1040.
- Use a credit or debit card using a pay-by-phone system or the Internet.

Payment Due Dates

For the purpose of paying estimated tax, the year is divided into four parts, and payment is made according to the table below:

Estimated Tax Payment Due Dates	
Period	**Due Date**
January 1–March 31	April 15
April 1–May 31	June 15

June 1–August 31	September 15
September 1–December 31	January 15

State and Local Income Taxes

State and local income taxes are deductible on Schedule A in the year paid. If the taxpayer elects to deduct state and local taxes, this amount should include taxes from state tax withholding on the W-2. It could also include taxes withheld from 1099s. Other taxes that would be included in this category are estimated state taxes paid in the year or payments made for prior year returns.

Employment Taxes

The payroll tax, referred to as FICA (for the Federal Insurance Contributions Act), is comprised of Social Security and Medicare taxes. Like federal withholding, these taxes are withheld by and remitted to the government by the employer (for an employed person, as contrasted with an independent contractor or self-employed person). These amounts are said to be put into a trust fund that the federal government will pay out to the contributor in the form of Social Security and Medicare benefits. The employer is required to make periodic deposits and file annual and quarterly summaries.

California Withholding

Employment Development Department (EDD) Form DE-4 is used to tell a California employer how much to withhold from wages. The amount is based on the taxpayer's allowances claimed on the DE-4 and the taxpayer's estimate of income for the year.

A nonresident taxpayer may need to prepay tax if certain non-wage payment is received, including:

- trust distributions
- partnership and LLC distributions
- rents
- royalties
- gambling winnings

Backup Withholding – California

A payer of such non-wage income must withhold 7 percent from income in excess of $1,500 (during the calendar year). For a taxpayer failing to provide a correct taxpayer identification number or to certify exemption from backup withholding, a payer must withhold 7 percent of California income. Backup withholding replaces all other types of withholding and cannot be reduced or waived.

Special rules apply to California real estate withholding.

Household Employees

In line with nationwide efforts to close the tax gap and ensure all individuals pay the correct amount of tax, the Internal Revenue Service and a number of state agencies, including California taxing authorities, have begun to devote more attention in recent years to the area of household employees.

Employer

An individual who pays wages to one or more people to work as employees in or around his or her home on a full-time, part-time, or even temporary basis may be considered to be a household employer. However, not every person who performs work for the benefit of a taxpayer in this situation can be considered an employee.

The following table offers some examples of the type of workers that are typically considered household employees versus those that are not employees of the homeowner.

Household Employees	Not Household Employees
Cooks	Self-employed carpenters
Gardeners	Workers employed by a lawn service company
Housekeepers	Plumbers employed by an independent company
Home health aides	Nurses leased from a temporary employment agency
Pool maintenance workers	Workers employed by a pool maintenance company

Wages

Wages paid to an employee can take many forms, such as cash, check, or non-cash compensation, such as the fair value of meals and lodging. The main point is that all compensation an employee receives for his or her personal services is considered to be wages, and as such, they are potentially subject to taxation. This principle applies regardless of whether a worker is engaged on a casual or temporary basis, as a day laborer, or as part-time or full-time. Other payments related to the employee’s job, such as performance bonuses, commissions, overtime pay, and vacation pay, are also regarded as wages.

Withholding from Wages

A household employer who employs one or more people to perform work on his or her behalf may be subject to the requirement to withhold payroll taxes from the wages of the employee(s). The threshold for this requirement is when the employer pays a total of $750 or more in cash wages to an employee within a calendar quarter.

The employer must register with the Employment Development Department (EDD) within 15 days of reaching or passing the $750 mark. Registration can be performed by telephone, online, or by filing Form DE 1HW, Registration Form for Employers of Household Workers.

When completing this registration, the employer has the option to elect to pay his or her payroll tax obligations on an annual basis rather than quarterly, which is the default option. However, if the employer pays a combined total of $20,000 or more in wages during the year, then the associated payroll taxes must be remitted to the EDD on a quarterly basis.

There are thus two types of household employers in terms of their reporting requirements:

- quarterly employers
- annual employers

Their obligations can be summarized as follows:

Type of Employer	Reporting Wages	Paying Taxes
Quarterly	Quarterly	Quarterly
Annual	Quarterly	Annually

Regardless of whether an employer pays taxes annually or quarterly, employee wages and withholding are reported each quarter according to the schedule below. When the due date falls on a Saturday, Sunday, or legal holiday, the next business day is considered to be the last timely date.

Report Covering	Filing Due Dates
January–March	April 1
April–June	July 1
July–September	October 1
October–December	January 15 (the next year)

Forms for Reporting

As mentioned above, the main difference between annual and quarterly employers is the frequency of their payments of taxes related to their employees' wages. The table below summarizes the related forms and reporting intervals.

Reporting Intervals		
Employer Type	**Quarterly**	**Annually**
Quarterly	**DE 9**: Quarterly Contribution Return and Report of Wages	N/A

	DE 9C: Quarterly Contribution Return and Report of Wages – Continuation **DE 88**: Payroll Tax Deposit (with payment)	
Annually	**DE 3BHW**: Employer of Household Workers Quarterly Report of Wages and Withholding	**DE 3HW**: Employer of Household Workers Annual Payroll Tax Return (with payment)

Payroll Taxes

The type(s) of payroll taxes that the employer must withhold from the employee's wages depends on the total amount of wages paid to the employee during the calendar quarter. Please see the following table.

Quarterly Wages	Withholding Requirement
Below $750	None
From $750 to $999.99	State Disability Insurance (SDI) only
$1,000 or above	State Disability Insurance (SDI), Unemployment Insurance (UI), and Employment Training Tax (ETT)

While household employers are not required to withhold California income tax from the employee's wages, they are still required to report to the EDD the taxable wages paid to each employee.

Value of Meals and Lodging

Household employees sometimes receive meals and lodging as part of their working arrangements. Household employers need to be aware that such meals and lodging may need to be valued and taxed. For employees who are covered under a contract of employment or union agreement, the taxable value of meals and lodging should not be less than the estimated value stated in that document. If the cash value is not stated in an employment contract or union agreement, the tables and information below supplied by the EDD can be used to determine the value of the meals and/or lodging an employer provides to his or her employees.

Value of Meals					
Year	**Three Meals per Day**	**Breakfast**	**Lunch**	**Dinner**	**Other**
2022	$12.95	$2.65	$4.00	$6.30	$4.65
2023	$13.95	$2.85	$4.25	$6.75	$4.95
2024	$14.85	$3.05	$4.55	$7.25	$5.35

To calculate the value of lodging for a taxpayer, multiply the amount that he or she could rent the property for (ordinary rental value) by two-thirds (0.667). Ordinary rental value may be calculated on a monthly or weekly basis. The table below shows the minimum and maximum amounts to report for lodging.

Value of Lodging		
Year	**Minimum per Week**	**Maximum per Month**
2023	$57.05	$1,759
2024	$60.06	$1,852

Calculating the Taxable Amounts

Lodging and meals (noncash compensation) are ignored when calculating whether the employer has reached the $750 and $1,000 thresholds for registration and withholding but are taken into account when calculating the basis on which the applicable payroll taxes should be calculated.

Examples

Example 1

George paid his gardener a total of $720 in cash during the last quarter and provided meals for him to the value of $100. George can ignore the $100 value of the meals provided to the gardener because he has not yet reached the cash wage limit of $750. He is thus not required to register with the EDD.

Example 2

Martha paid her home health aide a total of $790 in cash during the last quarter and provided meals for her to the value of $50. Martha must now register with the EDD because she has passed the $750 threshold. She must also withhold State Disability Insurance Tax (SDI) and must do so on the entire $840 in compensation that the employee received.

Example 3

Nancy paid her housekeeper a total of $850 in cash during the last quarter and provided meals for her to the value of $200. Nancy must now register with the EDD because she has passed the $750 threshold. She must also withhold SDI based on the entire $1,050 in compensation that the employee received. She is not required to pay UI and ETT because her total cash wages paid have not yet passed the $1,000 mark.

Example 4

Keith decided to outsource the maintenance of his swimming pool and paid a part-time employee a total of $1,180 in cash during the last quarter and provided meals for him to the value of $100. Keith must now register with the EDD because he has passed not only the $750 threshold but also the $1,000 mark. He must withhold SDI and pay UI and ETT on the entire $1,280 in compensation that the employee received.

Wage Variations

Although an employer may have registered with the EDD and started to report and pay taxes related to his or her employees, there is always the possibility that the number of employees and the amount of wages paid may vary over time. Increases in employees and wages paid are easily accounted for in the quarterly reporting process, but reductions in subsequent quarters below the $750 and $1,000 wage threshold amounts call for different treatment.

For Employers Liable for SDI Only

If the wages paid by an employer fall below $750 in a given quarter, the employer must continue to withhold SDI from his or her employee's wages for the remainder of the current year and for the entire calendar year that follows.

For Employers Liable for SDI, UI, and ETT

If the wages paid by an employer fall below $1,000 in a given quarter, the employer must continue to withhold SDI from his or her employee's wages for the remainder of the current year and for the entire calendar year that follows. The employer must also continue to pay UI and ETT for the same period (until the end of the following calendar year).

Withholding on California Real Estate

For taxable years beginning on or after January 1, 2009, when California real estate is sold on an installment basis, the buyer is required to withhold on the principal portion of each installment payment an amount based on either 3 percent of the total sales price or the Optional Gain on Sale withholding amount (12.3 percent of the gain) from Form 593.

Form 593 must be certified by the seller. If the taxpayer is the buyer, he must withhold on the principal portion of each installment payment. Withholding payments must be submitted within 20 days following the end of the month in which the real estate transaction occurred.

Sellers may be eligible for a release from withholding on installment payments following the close of escrow. To elect out of withholding on installment payments from the sale of California real property, the seller must fulfill several requirements. He must file a California income tax return and report the entire gain on Schedule D-1 in the year of the sale.

Other situations that do not require withholding include transactions where the total sales price (regardless of the number of parcels included in the single transaction) is $100,000 or less and certain foreclosed-upon properties.

There are withholding requirements for sales of California real property closing on or after January 1, 2008. Real estate withholding is a prepayment of California state income tax for sellers of California real property.

Real estate withholding is not an additional tax on the sale of real estate. It is a prepayment of the income (or franchise) tax due on the gain from the sale of California real property.

California law requires real estate withholding whenever there is a transfer of title on California real property.

Examples include:

- sales or transfers of real property (including exchanges)
- leaseholds/options
- short sales
- easements
- personal property sold with real property (if not stated separately)
- deferred exchanges
- vacant land

The requirement to withhold is the responsibility of the buyer but may be performed by the real estate escrow person (REEP) on the buyer's behalf.

Unless an exemption applies, all of the following are subject to real estate withholding:

- individuals
- corporations
- partnerships
- limited liability companies
- estates
- trusts
- real estate investment trusts (REITs)
- relocation companies
- bankruptcy trusts and estates
- conservatorships

Real estate withholding requirements based on sale price:

- total sales price is $100,000 or less—no withholding requirement:
    - When there are multiple sellers, the withholding is determined by the total sales price, not each seller's portion.
    - when there are sales of multiple parcels and/or family units (duplex, triplex, etc.) within the same escrow agreement so they constitute one transaction for purposes of determining the withholding requirements
- combined sale price of all parcels exceeds $100,000—withholding required:
    - when the seller is a corporation with no permanent place of business in California immediately after the sale
    - when the seller is an individual or any other type of entity except a partnership
    - even if the sales price of each separate parcel in the same escrow transaction is under $100,000

Sellers who meet the above criteria may still qualify for a full or partial exemption. However, the law does not provide for early refunds of taxes withheld on sales of real estate. The taxpayer must file his or her California tax return to claim the amount withheld.

Sellers are exempt from withholding if the:

- property qualifies as his or her principal residence (IRC §121)
- property was last used as his or her principal residence (IRC §121)
- sale will result in a loss or zero gain for California tax purposes
- transaction will qualify as a like-kind exchange, with some exceptions (IRC §1031)
- transaction will qualify as an involuntary conversion (IRC §1033)
- transaction will qualify for non-recognition treatment under IRC §351 (transfer to a corporation controlled by the transferor) or IRC §721 (contribution to a partnership in exchange for a partnership interest)
- seller is a corporation with a permanent place of business in California
- seller is a partnership
- seller is an LLC classified as a partnership for federal and California income tax purposes, which is not a single-member LLC that is disregarded for federal and California income tax purposes
- seller is a tax-exempt entity
- seller is an insurance company, individual retirement account (IRA), qualified pension plan, or charitable remainder trust

Sellers who meet one of the above exemptions must sign a written certification under penalty of perjury to be exempt from withholding.

As the seller, the taxpayer may choose between the two withholding calculation methods available:

- total sales price method
- alternative withholding calculation method

Real estate escrow persons and Qualified Intermediaries (QIs) are not authorized to provide legal or accounting advice for purposes of determining withholding amounts. The Franchise Tax Board encourages sellers to consult with a tax professional for this purpose.

To calculate the withholding using the Total Sales Price Method, the taxpayer multiplies the total sales price or boot by 3 percent (.0333). Boot is defined as the money, debt relief, or the fair market value of "other property" received by the seller in an exchange in addition to replacement property.

To calculate the withholding using the alternative withholding calculation method, also known as the optional gain on sale election method, the taxpayer multiplies the estimated gain calculated on FTB Form 593-E, Real Estate Withholding - Computation of Estimated Gain or Loss, by the seller's or transferor's maximum tax rate.

If the taxpayer elects to compute withholding using the alternative withholding calculation method, he or she is required to:

- complete and sign FTB Form 593-E (the form he or she used to calculate the amount of his or her loss or gain for withholding purposes)
- sign FTB Form 593, Real Estate Withholding Tax Statement

By signing these forms, the taxpayer certifies under penalty of perjury that the gain shall not be less than the gain required to be recognized. California law requires the taxpayer to keep Form 593-E for his or her records for five years. The FTB may review relevant escrow information to ensure withholding compliance.

Knowledge Check

Test Your Knowledge!

When is a buyer required to withhold on a real estate purchase in California?

when the sales price exceeds $200,000

This answer is incorrect. The threshold is not based solely on sales price, and this is not the correct threshold.

on all real estate purchases

This answer is incorrect. Withholding is not required on all transactions.

only when the seller is a corporation

This answer is incorrect. Withholding can apply to sellers other than corporations.

when the sales price is over $100,000 except for exempt transactions

Correct. Withholding is required on sales over $100k unless an exemption applies.

Summary

This chapter covered issues related to the different ways taxing authorities get a steady stream of revenue and ensure that appropriate tax is paid. You will learn about withholding from wages, what happens when certain mistakes are made that require a payor to keep extra withholding, the requirements to make estimated tax payments during the year, and various penalties associated with underpayment of tax during the year.

Special attention is paid to household employees and the rules that must be followed by their employers. More specifically, you learned about the following:

- federal and California withholding of payroll taxes and income tax
- how employers get the information they need to withhold the correct amount of tax
- the rules for making estimated tax payments during the year
- penalties for underpayment of tax during the year
- special withholding rules for certain real estate transactions in California

Key points to remember include the following:

- **Estimated payments**: Federal and state tax are pay-as-you-go through withholding and estimated payments
- **Timing of estimated payments**: Estimated payments of income tax are generally made quarterly to avoid penalties
- **Household employers**: Household employers must register with EDD at $750 quarterly wage threshold
- **Real estate buyers**: Real estate buyers must withhold 3% of sales price or estimated gain for CA property sales over $100k
- **Payments from employer—some are taxable wages; some are not taxable**: Compensation in the form of cash, bonuses, meals, and lodging are considered taxable wages; certain fringe benefits like health insurance are non-taxable. This helps correctly calculate withholding taxes, among other things.

Glossary

adjusted gross income—California adjusted gross income is your federal adjusted gross income from all sources reduced or increased by all California income adjustments.

airdrop—a distribution of cryptocurrency to multiple taxpayers' ledger addresses

blockchain—a ledger of cryptocurrency transactions

California AGI—gross income and deductions derived from California sources for any part of the taxable year during which the taxpayer was a nonresident plus all items of gross income and all deductions, regardless of source, for any part of the taxable year for which the taxpayer was a resident

California itemized or standard deductions—determined by applying the ratio of California AGI to total AGI to all itemized or standard deductions allowed to California residents

California qualified stock options—options issued after January 1, 1997, and before January 1, 2002 (When California Code §17502 requirements are met, there is favorable tax treatment for these options—the same treatment that is given to incentive stock options.)

California taxable income—California AGI less California itemized or standard deductions

cryptocurrency—a type of virtual currency that uses cryptography (codes) to secure digital transactions

disqualifying disposition—a disposition of the stock options that does not meet IRC §422 or 423 holding period requirements

dividend—income paid out of a company's earnings and profits to the owners of the company (i.e., the owners of the company's stock) (Dividends can be made in the form of cash, additional shares of stock, or as part of a liquidation of the corporation.)

earnings and profits—the amount a company earns after subtracting all of its expenses (This figure is sometimes referred to as net earnings or net income. It is a tax term, and for financial analysis purposes, it is the measure of a company's ability to pay dividends to its shareholders.)

earnings per share—This amount indicates how much income a company earns for each share of its stock. A higher EPS generally means the company has a higher value.

exercise date—the date the employee purchases the actual stock at the option price

Franchise Tax Board (FTB)—The California Franchise Tax Board (FTB) collects state personal income tax and corporate income tax of California. It is part of the California State and Consumer Services Agency. The Board is composed of the California State Controller, the director of the California Department of Finance, and the chair of the California Board of Equalization. The chief administrative official is the executive officer of the Franchise Tax Board.

grant date—the date the company grants (gives) the option to the employee

gross income—California gross income is all income you receive in the form of money, goods, property, and services from all sources that are not exempt from tax. Gross income does not include any adjustments or deductions.

hard fork—a cryptocurrency goes through a change in its protocol (the set of rules allowing data exchanges between computers); the change turns the cryptocurrency into a new cryptocurrency on a new ledger

liquidating distribution—a company's return of capital to shareholders as part of the company's partial or complete liquidation (or shutting down) (Such distributions are not paid from earnings. The funds represent the return of an investor's invested capital.)

non-statutory stock options—stock option plans that do not meet the requirements of IRC §§ 421 through 424 (Such plans are governed by IRC §83.)

off-chain transaction—transaction not recorded on a distributed ledger

on-chain transaction—transaction recorded on a distributed ledger

option price—any price the employee pays for the stock option

permanent change of station orders (PCS)—In the United States Armed Forces, a permanent change of station (PCS) is the official relocation of an active duty military service member—along with any family members living with her or him—to a different duty location, such as a military base. A permanent change of station applies until muted by another PCS order, completion of active duty service, or some other such preemptive event. This should not be confused with a permanent change of assignment (PCA), which describes the reassignment of active duty personnel to a new unit within the same military post. This term is also used for other United States government employees, such as foreign service officers, special agents, diplomats, and other civilian, non-military personnel stationed in embassies and consulates around the world.

qualifying disposition—a disposition of the stock options that meets IRC §422 or 423 holding period requirements

receipt of cryptocurrency—occurs when the recipient can transfer, sell, exchange, or otherwise dispose of it

registered domestic partners (RDPs)—California Family Code §297 provides that "domestic partners are two adults who have chosen to share one another's lives in an intimate and committed relationship of mutual caring."

registered domestic partnership (RDP)—A domestic partnership is established in California when both persons file a Declaration of Domestic Partnership with the California Secretary of State, and at the time of filing, either both persons are members of the same sex or one or both of the persons is/are over the age of 62 and meet the eligibility criteria under Title II of the Social Security Act as defined in 42 U.S.C. §402(a) for old-age insurance benefits or Title XVI of the Social Security Act as defined in 42 U.S.C. §1381 for aged individuals.

same-sex married couples (SSMC)—Same-sex married individuals are adults of the same sex who were legally married in California (during the window when same-sex marriages were legal) or out of the state in a state or country that performs legal same-sex marriages.

soft fork—A ledger has a change in protocol but the change does not cause the creation of a new cryptocurrency.

statutory stock options/incentive stock options—stock option plans that meet the requirements of IRC §§ 421 through 424

stock dividends—Stock dividends are shareholder payments made in the form of stock shares rather than cash. This type of dividend helps a company avoid reducing its cash balance. Because this type of dividend results in more shares of stock representing the same amount of company value, the value per share (i.e., earnings per share) is diluted.

stock—a proportion of ownership of a corporation; a corporation issues shares of stock to raise money from purchasers who become owners of the corporation

stock split—one form of a stock dividend; the corporation issues more shares to current stock owners, usually to make the shares more marketable because of their reduced price

temporary duty assignments—A temporary duty assignment (TDA), also known as "temporary additional duty" (TAD), "temporary duty travel" (TDT), or "temporary duty" (TDY), refers to a U.S. government employee travel assignment at a location other than the employee's permanent duty station. They are usually of relatively short duration, typically from two days to two months in length. Not all agencies use this designation. A temporary duty assignment can be to any location, be it 50 or 5,000 miles away, and some government agencies, including the Defense Department, mandate they be less than six months in duration.

total AGI—adjusted gross income from all sources for the entire taxable year

total taxable income—the California AGI divided by the total AGI (the result cannot exceed 1.0)

vesting date - restricted stock—the date the stock options become exercisable and taxable

vesting date - unrestricted stock—the date the stock options become exercisable

virtual currency—a digital representation of value other than a “real currency” (U.S. dollar or foreign currency); it functions as a store of value and a medium of exchange

End Notes

[1] Dynamex, 4 Cal.5th at 958

[2] https://www.labor.ca.gov/employmentstatus/faq/

[3] https://www.cdtfa.ca.gov/taxes-and-fees/rates.aspx

[4] https://www.irs.gov/taxtopics/tc556

[5] https://www.ftb.ca.gov/about-ftb/newsroom/tax-news/december-2020/all-about-business.html

Final Exam

2024 California Personal Income Tax

The following exam is attached only for your convenience. The questions below are the actual exam questions that you will be given when taking the online exam. Please log into your account online and take the Final Exam from the course details page where you will be allowed to submit your answers. A passing score of 70 percent or better will receive course credit and a Certificate of Completion.

1. Which of the following is true about the status of California workers?

A. They are assumed to be independent contractors.
B. They are assumed to be employees.
C. They are assumed to be gig workers.
D. They are assumed to be part of the sharing economy.

2. For individuals who reach age 72 after December 31, 2022, and before January 1, 2033, what is the minimum age at which they must beginning taking required minimum distributions?

A. age 70
B. age 71
C. age 72
D. age 73

3. What is the ABC test used for in California?

A. to determine if a worker is an independent contractor or an employee
B. to determine if a worker is eligible for unemployment insurance
C. to determine if a worker is eligible for disability insurance
D. to determine if a worker is eligible for paid family leave

4. Which agency is responsible for administering the California sales and use tax?

A. California Franchise Tax Board
B. United States Internal Revenue Service
C. California Department of Tax and Fee Administration
D. county tax assessors

5. Who is responsible for paying the Unemployment Insurance Tax?

A. the employee
B. the employer
C. both the employee and the employer
D. the state government

6. What is the rate of the alternative minimum tax (AMT) in California?

A. 6.65 percent

B. 7 percent
C. 8.65 percent
D. 10 percent

7. Who is responsible for administering the state income tax program in California?

A. Internal Revenue Service (IRS)
B. Franchise Tax Board (FTB)
C. California Department of Finance
D. U.S. Department of Treasury

8. A military service member is stationed in California on PCS orders. For California state tax purposes, what is their residency status?

A. They are considered a nonresident as long as they are under PCS orders.
B. They are considered a resident, even when sent on temporary duty assignments outside of California.
C. Their residency is determined by their home of record when they first joined the military.
D. They can choose their residency status based on personal preference.

9. In determining California residency, the "nine-month rule" serves as which of the following?

A. an automatic method to classify a taxpayer as a resident
B. a guideline for making a residency determination
C. a hard and fast rule to eliminate any ambiguity
D. a tiebreaker

10. California nonresidents are taxed by California on which of the following?

A. none of their income
B. all of their worldwide income
C. their California-source income
D. all of their investment income

11. What are the three categories a taxpayer's residency status can fall into?

A. resident, part-year resident, nonresident
B. resident, temporary resident, permanent resident
C. resident, citizen, immigrant
D. resident, non-citizen, alien

12. What is the filing status of a taxpayer who was not married or in a registered domestic partnership, divorced or became legally separated, or did not remarry or enter into another RDP during the tax year?

A. married filing separately
B. single
C. head of household
D. qualifying widower

13. Which of the following is considered separate property in California?

A. anything owned by either spouse before the marriage
B. income derived from community assets during the marriage
C. property purchased by one spouse with community property funds
D. all income earned by either spouse during the marriage

14. Otto and Copper are a married couple with an adopted child, Maximilian, whom they claim as a dependent. Maximilian lives with Otto and Copper all year, and all expenses are paid by Otto and Copper. Copper dies during 2024. How long can Otto use the filing status of qualifying widower/surviving spouse?

A. until the year of Otto's death
B. until Otto sells the house
C. 2026
D. 2027

15. Millicent is a single mother with two children, ages 10 and 12. She pays for more than half of the cost of keeping up her home, and her children live with her for more than half the year. Millicent's ex-husband does not live with her or the children and does not provide any financial support for them. Which of the following requirements does Millicent meet to qualify her to file as head of household?

A. Millicent must be married on the last day of the year.
B. Millicent must have paid less than half the cost of keeping up a home for the year.
C. Millicent's children lived with her for less than half the year.
D. Millicent's children lived with her for more than half the year, except for temporary absences.

16. Taxpayer Tim wants to use head of household status on his 2023 tax return. You ask him some questions about his living situation for the year. Which of the following would disqualify Tim from using the HOH filing status?

A. Tim's nine-year-old son Maurice lives with him all year except for the two weeks little Maurice spends at summer camp.
B. Tim pays about 2/3 of the cost of maintaining the home for the year.
C. Tim's wife lives with him and his son Maurice and pays the other 1/3 of the cost of maintaining the home.
D. Tim is a legal resident of the United States but is not a citizen.

17. What is the starting point for calculating income tax in California?

A. federal AGI
B. state AGI
C. gross income
D. net income

18. Which of the following is earned income?

A. interest from savings
B. dividends from investments

C. salary from a job
D. capital gains from a sale of property

19. Rudyard is a resident of North Carolina for all of the tax year. He travels to California from time to time for his job. He earns $40,000 in wages in California, $20,000 in wages in North Carolina, $10,000 in interest from a bank account in Texas, and $5,000 in interest from a bank account in California. How much California income does Rudyard have?

A. $0
B. $45,000
C. $55,000
D. $75,000

20. Which of the following is true about the relationship between a federal tax return and a California tax return?

A. The two returns are the same, other than the requirement to use different tax rates on the California return.
B. Federal AGI is used as the starting point for completing the California return.
C. The two returns are unrelated and must be completed independently of each other.
D. California AGI is used as an adjustment to the federal return.

21. Which of the following types of income is not subject to backup withholding?

A. interest payments
B. unemployment compensation
C. dividends
D. gambling winnings

22. Which of the following is not considered a household employee?

A. cooks
B. gardeners
C. self-employed carpenters
D. home health aides

23. Which form is used to indicate to a California employer how much to withhold from wages?

A. DE-4
B. 1040
C. 540-W
D. W-2

24. What is the purpose of form W-4?

A. to report annual income to the IRS
B. to determine the amount of federal income tax withholding from an employee's paycheck
C. to apply for a tax refund
D. to report self-employment income

25. What is the purpose of EDD Form DE-4?

A. to report employee terminations to the state
B. to inform a California employer of the amount to withhold from wages
C. to register a new business with the state
D. to apply for unemployment benefits