

2010 Annual Income Tax Seminar California Residency – A Primer

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Dennis Brager is a California State Bar Certified Tax Specialist, and a former Senior Tax Attorney for the Internal Revenue Service's Office of Chief Counsel. In addition to representing the IRS in court, he advised the Service on complex civil and criminal tax issues. He now has his own four attorney firm in Westwood, and has been named as a "Super Lawyer" in the field of Tax Litigation by *Los Angeles Magazine*. He has been quoted as a tax expert, by *Business Week*, the *Daily Journal*, the *National Law Journal*, *The Daily Beast*, *USA Today*, and *Palm Beach Daily News*.

Having worked for the IRS for six years, he gained valuable insight into the inner workings of that organization. This not only helps in developing the right strategies, but facilitates working with the system quickly and efficiently. Mr. Brager has limited his practice to representing clients having disputes with the IRS, the Franchise Tax Board, the State Board of Equalization and the Employment Development Department--both at trial and administrative levels.

He has appeared on ABC Television's Good Morning America show, Fox Business News, and TV One Access. He has also spoken before the California Continuing Education of the Bar, the California Society of CPAs, the UCLA Tax Controversy Institute, the California State Bar Tax Section, the Consumer Rights Litigation Conference, the California Trial Lawyers Association, the American Bar Association, the Warner Center Estate and Tax Planning Council and the National Association of Enrolled Agents. Dennis Brager has been an instructor at Golden Gate University's Masters in Taxation Program and a guest speaker at the University of Southern California. Mr. Brager has testified as an expert witness on Federal tax matters.

His articles have appeared in the *California Lawyer*, *Daily Journal*, *Taxation for Lawyers*, *Los Angeles Lawyer*, *The Consumer Advocate*, *Family Law News*, *California Tax Lawyer*, *Journal of Tax Practice and Procedure*, and *Journal of Taxation of Investments*. They include "The Tax Gap and Voluntary Disclosure," "Circular 230: An Overview," "Recent Developments in Tax Procedure," "Damages, Rescission and Debt Cancellation as Client Income," "Ponzi Scheme Victims May Be Able to Mitigate Losses with Tax Deduction," "Prevailing Party-Recovering Attorneys Fees From the IRS," "The Taxpayer Bill of Rights--A Small Step Toward Reining in the IRS," "Challenging the IRS Requires a Cohesive Strategy," "The Innocent Spouse Defense," "IRS Guidelines for Installment-Payment Agreements," "Expert Advice: New Rules on 1099 Forms," "Tax Brakes: The Taxpayer Bill of Rights 2," and "Expert Advice: Avoiding Payroll Taxes."

Mr. Brager received his undergraduate degree from Pace University (B.B.A., magna cum laude, 1975, Accounting/Finance), and his law degree from New York University (J.D., 1978). He is a former chair of both the Tax Compliance, Procedure and Litigation Committee of the Los Angeles County Bar Association, and the California State Bar, Tax Procedure and Litigation Committee. He is admitted to practice before the U.S. Supreme Court, the Ninth Circuit Court of Appeals, U.S. Claims Court, U.S. Tax Court, U.S. District Court and the U.S. Bankruptcy Court.

California Residency-- A Primer

I. California income taxes are imposed on the entire taxable income of every resident of our great state. Rev. & Tax. Code Section 17041(a)(1).

II. Who is a resident.

A. Included within the California tax law definition of "resident" is "[e]very individual who is in this state for other than a temporary or transitory purpose" and "[e]very individual domiciled in this state who is outside the state for a temporary or transitory purpose." Rev. & Tax. § 17014 (a)(1) & (a)(2). "Any individual who is a resident of this state continues to be a resident even though temporarily absent from the state." Rev. & Tax. § 17041(c).

B. Domicile, Residency-- A confusing mix

1. [The term] "domicile" properly denotes the one location with which for legal purposes a person is considered to have the most settled and permanent connection, the place where he intends to remain and to which, whenever he is absent, he has the intention of returning but which the law may also assign to him constructively. Residence, on the other hand, denotes any factual place of abode of some permanency, that is, more than a mere temporary sojourn [citation omitted]. While a person can have in law only one domicile [citation omitted], he may have several "residences" for different purposes as well as more than one "residence" for tax purposes [citation omitted]. *Whittell v. Franchise Tax Board* 231 Cal.App.2d 278,284 (1964).
2. A person may be a resident for income tax purposes although domiciled elsewhere and vice versa. *Id.* at 285
3. A person whose domicile is in another state or country will be taxed in California if he or she is found to be a "resident" of California. Similarly, a person who is domiciled in California may escape California tax if he or she is not a "resident" of California. *Appeal of Raymond H. and Margaret R. Berner*. 2001-SBE-006-A
4. An individual may claim only one domicile at a time. 18 Cal. Code Regs. § 17014. (c).
5. "Domicile" refers to the place where individuals have their true, fixed, permanent home and principal establishment, and to which place they have, whenever they are absent, the intention of returning. "It is the place in which a [person] has voluntarily fixed the habitation of [themselves] and [their] family, not for a mere special or limited purpose, but with the present intention of making a permanent home." 18 Cal. Code Regs. § 17014. (c).
6. If an individual acquires the status of a resident by virtue of being physically present in the State for other than temporary or transitory purposes, he remains a resident even though temporarily absent from the State. *If, however, he leaves the State for other than temporary or transitory purposes, he thereupon ceases to be a resident.* If an individual is domiciled in this

State, he remains a resident unless he is outside of this State for other than temporary or transitory purposes. 18 Cal. Code Regs. § 17014.

7. In order to change domicile, a taxpayer must actually move to a new residence and intend to remain there permanently or indefinitely. *In re Marriage of Leff* (1972) 25 Cal.App.3d 630, 642; *Estate of Phillips* (1969) 269 Cal.App.2d 656, 659.
 - a) While an individual's intent will be considered when determining domicile, intent will not be determined merely from unsubstantiated statements; the individual's acts and declarations will also be considered. *Appeal of Joe and Gloria Morgan*, 85-SBE-078 (July 30, 1985.)

C. Temporary or Transitory.

1. The determination of whether or not an individual is present in or absent from California for a temporary or transitory purpose depends largely upon the facts and circumstances of each case. 18 Cal. Code Regs. § 17014(b);
2. The determination cannot be based solely on the individual's subjective intent, but must instead be based on objective facts. *Appeal of Anthony V. and Beverly Zupanovich*, 1976 Cal Tax Lexis 128 (Jan 6, 1976). In situations where an individual has significant contacts with more than one state, the state with which the individual maintains the closest connections during the taxable year is the state of residence. 18 Cal. Code Regs. § 17014(b);
3. [I]f an individual is simply passing through this State on his way to another state or country, or is here for a brief rest or vacation, or to complete a particular transaction, or perform a particular contract, or fulfill a particular engagement, which will require his presence in this State for but a short period, he is in this State for temporary or transitory purposes, and will not be a resident by virtue of his presence here. If, however, an individual is in this State to improve his health and his illness is of such a character as to require a relatively long or indefinite period to recuperate, or he is here for business purposes which will require a long or indefinite period to accomplish, or is employed in a position that may last permanently or indefinitely, or has retired from business and moved to California with no definite intention of leaving shortly thereafter, he is in the State for other than temporary or transitory purposes, and, accordingly, is a resident taxable upon his entire net income even though he may retain his domicile in some other state or country. 18 Cal. Code Regs. §17014
4. Closest Connections. Some of the factors as set forth in *Appeals of Stephen D. Bragg*
 - a) The location of all of the taxpayer's residential real property, and the approximate sizes and values of each of the residences;
 - b) The state wherein the taxpayer's spouse and children reside;
 - c) The state wherein the taxpayer's children attend school;
 - d) The state wherein the taxpayer claims the homeowner's property tax exemption on a residence;
 - e) The taxpayer's telephone records (i.e., the origination point of taxpayer's telephone calls);
 - f) The number of days the taxpayer spends in California versus the number of days

the taxpayer spends in other states, and the general purpose of such days (i.e., vacation, business, etc.);

- g) The location where the taxpayer files his tax returns, both federal and state, and the state of residence claimed by the taxpayer on such returns;
- h) The location of the taxpayer's bank and savings accounts;
- i) The origination point of the taxpayer's checking account transactions and credit card transactions;
- j) The state wherein the taxpayer maintains memberships in social, religious, and professional organizations;
- k) The state wherein the taxpayer registers his automobiles;
- l) The state wherein the taxpayer maintains a driver's license;
- m) The state wherein the taxpayer maintains voter registration, and the taxpayer's voting participation history;
- n) The state wherein the taxpayer obtains professional services, such as doctors, dentists, accountants, and attorneys;
- o) The state wherein the taxpayer is employed;
- p) The state wherein the taxpayer maintains or owns business interests;
- q) The state wherein the taxpayer holds a professional license or licenses;
- r) The state wherein the taxpayer owns investment real property; and
- s) The indications in affidavits from various individuals discussing the taxpayer's residency.

D. Safe Harbors

1. Individuals who are physically present within California for less than 6 months during the taxable year, and who are domiciled outside California and maintain their personal residence outside California are not California residents, provided they do not engage in any activity or conduct within California other than that of a seasonal visitor, tourist or guest. Rev. & Tax. § 17014(b).
2. Rev. and Tax. §17014(d) provides that for taxable years beginning on or after January 1, 1994, an individual domiciled in this state who is absent from California for an uninterrupted period of at least 546 consecutive days under an employment contract shall be considered outside of the state for a other than a temporary or transitory purpose.
 - a) Return visits to California that do not exceed 45 days are considered temporary. In effect, this makes any individual that is outside of the state for the required period of time under an employment contract a non-resident.
 - b) This safe harbor provision does not apply to any individual who has income from stocks, bonds, notes or other "intangible personal property" in excess of \$200,000 in any taxable year in which the employment contract is in effect.
 - (1) Employee stock options are not considered "intangible personal property". See *In the Matter of Donald Herman*, 1999 Cal. Tax Lexis 95 (SBE non-precedential decision).

E. Non-Residents. A California nonresident is simply anyone who is not a California resident. Rev. & Tax. § 17015.

F. Joint Return Issues

1. Married taxpayers must use the same filing status on their state income tax return as on their federal tax return. Rev.& Tax. § 18521(a)

2. A nonresident joint return must be filed if one spouse was a resident for the entire year and the other spouse was a nonresident for all or part of the year. Rev. & Tax. Section 18521(c). This rule does not apply if:
 - a) Either spouse was an active member of the United States armed forces.
 - b) Either spouse was a nonresident for the entire year and had no income from California sources during the year. Rev. & Tax. §18521(d).

III.A Residency Audit-- What to Expect. Review the FTB Residency and Sourcing Technique Manual.

<http://www.ftb.ca.gov/aboutFTB/manuals/audit/rstm/index.shtml>

A. In addition to determining whether the taxpayer is a resident of California The tax auditor's will focus on:

1. Determining the actual date the taxpayer became a resident since residents must report all income from all sources.
2. Determining what portion of a California nonresident's income is from a California source for those taxpayers leaving California.
3. Determining the date when income realization occurred. Did income realization occur before the taxpayer became a California resident, while he was a resident, or after he terminated his resident status?

B. FTB Tax Auditors are instructed to review the tax return, and prior and subsequent year tax returns for:

1. Responses to the residency questions contained on Schedule CA (540NR).
2. Large income from intangibles.¹²
3. Income, expenses, and deductions which may indicate connections within and without
4. Address on the return.
5. Address on the W-2s and 1099s.
6. State tax information on the W-2s.
7. Other addresses disclosed on the return.
8. Employer's address.
9. Address of tax preparer.
10. Federal identification numbers of partnerships, S corporations, and LLCs.
11. Social security number of taxpayer, spouse, and dependents.
12. Location of assets that were sold or exchanged.
13. Location of rentals and other investments.
14. Location of banks and financial institutions.
15. Location of farms on Schedule F.
16. Taxpayer's occupation.
17. Moving expense information (including reimbursement on W-2).
18. Investment activity (determine whether the taxpayer maintains a passive or active role in the activity).

19. Schedule C activity and address.

20. Closely held corporations.

21. Other state tax credit.

C. FTB tax auditors can also be expected to review databases for driver's license, vehicle registration, voter's registration, and property assessor information, as well as the Internet for news articles, business information, taxpayer profiles and historical information.

D. Some of the schedules that FTB Tax auditors are supposed to prepare in a residency tax audit include:

1. Personal Residences. For each personal residence located in California, the claimed state, or elsewhere that the taxpayer occupied during the years under audit, include:

- a) Purchase price, date of purchase, and assessed value.**
- b) Brief description of the residence.**
- c) Homeowner's/Renter's insurance policy.**
- d) Furnishings/shipment of household goods.**
- e) Homeowner's property tax exemption information.**
- f) Dates of occupancy.**

2. Personal Transportation. For each vehicle owned and registered by the taxpayer in California, the claimed state, or elsewhere (if relevant) during the years under audit, include:

- a) Make and model of the vehicle.**
- b) Dates of ownership.**
- c) States of registration.**
- d) Table reflecting vehicle expenses paid by the taxpayer, the date of payment, and the location of the payee. (Information obtained from financial database.)**

3. Pets. For any pets owned by the taxpayer during the years under audit, include:

- a) Type of pet.**
- b) Location of pet.**
- c) Listing reflecting the pet expenses paid by the taxpayers. Include the payee name, payee location, and the date of payment. (Information obtained from financial database.)**

4. Businesses. For each relevant business activity engaged in by the taxpayer during the years under audit, include:

- a) Business name and address.**
- b) Type of business.**
- c) Nature of the taxpayer's involvement in the activity.**

5. Employment. For each company the taxpayer worked for during the years under audit, include:

- a) Business name and address.**
- b) Type of business.**
- c) Nature of the taxpayer's duties.**

- d) Compensation received from the company.
 - e) Locations where the taxpayer performed services for the company.
6. **Voter Registration.** For each state the taxpayer was registered to vote in during the years under audit, include:
 - a) Date taxpayer registered to vote.
 - b) Voting history.
 - c) Status of voter registration.
 7. **Driver's License.** For each state the taxpayer maintained a valid driver's license during the years under audit, include:
 - a) Registration period.
 - b) Residence address listed on the license.
 - c) Status of driver's license.
 8. **Bank Accounts.** For each bank account maintained by the taxpayer during the years under audit, include:
 - a) Bank name and account number.
 - b) Type of account.
 - c) Branch location.
 - d) Date account opened and closed, if applicable.
 - e) Authorized signatories.
 - f) Table reflecting transaction activity locations.
 9. **Credit Cards.** For each credit card maintained by the taxpayer during the years under audit, include:
 - a) Credit card name and account number.
 - b) Date account opened and closed, if applicable.
 - c) Authorized signatories.
 - d) Combine all credit card transactions into one table reflecting transaction activity locations.
 10. **Family.** For any family members deemed relevant to the examination, include:
 - a) Name and relationship to the taxpayer.
 - b) Age, if a minor child, during the years under audit.
 - c) Location of the family member during the years under audit.
 11. **Memberships.** For each club, located in California, the claimed state, or elsewhere (if relevant) to which the taxpayer maintained a membership during the years under examination, include:
 - a) Name and address of the club.
 - b) Type of club.
 - c) Dates of membership.
 12. **Organizations.** For each organization to which the taxpayer belonged in California and the claimed state during the years under examination, include:
 - a) Name and address of the organization.
 - b) Type of club.
 - c) Dates of membership.
 - d) Nature of the taxpayer's involvement with the organization.

13. Professionals. For each medical, legal, accounting, or other professional relevant to the audit period, include:

- a) Professional's name and address.
- b) Listing of the payment dates. (Information obtained from financial database.)

E. Rev. & Tax. § 19504 authorizes the FTB to request and obtain information from third-parties. Notice must be provided to the prior to contacting third-parties. Rev. & Tax. §19054.7. The statute does not require notification of the specific person who will be contacted. However, the manual suggests that auditors will notify the taxpayer before contacting each third-party and give the taxpayer the opportunity to provide alternative sources of information .

IV. Burden of Proof. It's an uphill battle.

A. Respondent's determinations of residency are presumptively correct, and the taxpayer bears the burden of showing error in those determinations. *Appeal of Joe and Gloria Morgan, 58-SBE-078* (1985). The burden of proof as to a change of domicile is on the party asserting such change. *Appeal of Terance and Brenda Harrison, 85-SBE-059* (June 25, 1985).

B. If there is a doubt on the question of domicile after presentation of the facts and circumstances, the domicile must be found to have not changed. *Whitmore v. Commissioner* (1955) 25 T.e. 293; *Appeal of Anthony J. and Ann S. D 'Eustachio, 85-SBE-040*, (May 8, 1985.)

1. Note: This can work in the taxpayer's favor if it is clear that the taxpayer was initially domiciled outside of California.

V. Appeals.

A. At the close of the audit if the FTB determines that additional tax is due a *Notice of Proposed Assessment (FTB 5830) (NPA)* indicating the additional tax will be issued. If the taxpayer disagrees then you can file a protest within 60 days after the mailing of the notice. Rev. & Tax. § 19041.

1. The Protest should contain the following:

- a) Name and address.
- b) Social security number or taxpayer identification number.
- c) The amounts and taxable years.
- d) A statement of facts.
- e) An explanation of why the NPA is wrong.
- f) Points in support of your position, including authority supporting your position including legal references
- g) Signature of the authorized rep.
- h) Daytime telephone number
- i) A copy of the NPA

California Resident or Not?

