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ALERT

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California Residency Rules Ensnare Unwary Taxpayers

California's reputation as hard-nosed when it comes to finding ways to creatively assert tax liability is well-justified. Nonresidents frequently find themselves in the California Franchise Tax Board's (FTB) cross-hairs as susceptible targets for asserted tax liability based on a long list of factors that might be used to claim the agency has authority to impose tax on non-California income sources.

The question of residency in California continues to confound taxpayers who may not think they have sufficient ties to the state for tax collection. The lack of proper attention in planning to either avoid becoming a California resident for tax purposes, or to clearly sever ties upon moving to a new home outside the state, is an oversight that puts many taxpayers in danger of receiving significant tax assessments from the FTB that may not be resolved favorably once asserted and assessed.

Therefore, working with a tax professional in advance creates a greater likelihood of avoiding potential personal interaction with the FTB's residency unit in the future. The FTB has been known to frequently make assessments of income tax to unsuspecting former residents even years after moving away from the state. The FTB has the ability to collect on these assessments out-of-state and with an unlimited collection statute.

Expansive Residency Presumption

California has a broad statutory framework defining residency for tax purposes that can apply in two ways: residency is assumed for any individual who is in California for other than a temporary or transitory purpose, and it is likewise presumed for individuals who have domiciles within the state but are engaged in temporary and transitory activities outside California.[1] The basic administrative definition of domicile

[1] Cal Rev & Tax Code § 17014.

is having a fixed, permanent home within the state that one intends to return to whenever gone from that location.[2]

For individuals not domiciled in California but who are in the state long enough to enjoy the benefits and protection afforded by the state, a residency determination might arise based on the objective facts. A California statute presumes an individual is a resident if that person spends more than nine months within the state, although the presumption is rebuttable.[3] California does not have any clear definitions of how much time one can spend in the state to not be a resident, however. Thus, the facts of each person's case are critical to analyze. Other common indicia the FTB looks at in determining if residency exists are:

- State in which taxpayer holds driver's license;
- State where vehicles are registered;
- State in which financial transactions occur;
- Location of professionals taxpayer relies on (medical, legal, tax, etc.).

A residency status determination is important because California taxes residents on all income regardless of source. Nonresidents, on the other hand, are only taxed on income from California sources, such as wages earned while in California or the gain from the sale of California property.

Because the FTB's residency determination is presumed correct, the taxpayer has the burden of proof to establish the determination is incorrect. Thus, it is important to proactively engage in planning to avoid behavior that the FTB considers indicative of residency, and if the issue comes up, to promptly work with the FTB to avoid an unfavorable residency determination.

Heavy Burden on Taxpayers Leaving California

As one might expect, the FTB takes a dim view of California residents who move to a new location in a different state, particularly states with little or no income tax. The FTB frequently asserts that residency is still maintained – even when a taxpayer moves out of state – based on the agency's belief that residency indicia are still present that keep the taxpayer a resident for tax purposes. A taxpayer must intentionally and clearly indicate that they are cutting ties to California and setting up a new domicile elsewhere. This requires establishing a factual record that the taxpayer intended to abandon the California domicile and permanently and indefinitely stay at the new location.

Proving a change in domicile can be very difficult for taxpayers who leave California but retain significant connections – such as property interests or family/social ties – to the state. For example, a California couple reaching retirement age may decide to move to Nevada, but leave behind adult children who occupy a home owned by the parents that is not sold. The couple will likely face assertions by the FTB that the children's continued living in a family home in California means that the couple do not really intend to change their domicile.

Other common factors that the FTB relies upon as evidence of lingering residency:

- Active involvement in social clubs, alumni boards, church communities;

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[2] 18 CCR § 10714(c).
[3] Cal Rev & Tax Code § 17016.

- Number of days spent within California exceeds time spent out of state;
- Maintaining local financial accounts or mail delivery to a California location;
- Continued business operations within the state;
- Continued use of service providers in California, such as pet care, doctors and hairdressers.

FTB Filing Enforcement Program

Where the FTB believes an individual should have filed personal income tax returns but has not, the agency may initiate procedures under its Filing Enforcement Program (FEP). The FTB utilizes information from many sources in deciding whether it believes an individual may have a filing obligation. For example, income information obtained by the FTB regarding an individual's wages, interest, or sale of stock, as well as obtained occupational or local tax licenses and federal tax returns filed from a California address may indicate a California personal income tax return filing requirement. Once the determination is made that a potential filing obligation exists, the FTB will send out a request or demand for tax return. Failure to respond to the notices will result in the FTB issuing a Notice of Proposed Assessment. The difficulty with this procedure is that the FTB sends these FEP notices to the taxpayer's "last known" address, which typically was their former California address. The practical effect of FTB FEP notices is that many former California residents do not receive these notices and assessments are unilaterally made by the FTB.

In its 2012 annual report, the FTB Taxpayers' Rights Advocate noted that 47 percent of the FTB's outstanding tax receivables come from FEP notices. The FEP has been an active area for the FTB in concentrating on individuals the agency believes have sufficient nexus to the state to impose income tax liability. The FTB has recently focused on several indicators in asserting that some individuals have sufficient nexus and then developing a pro forma tax liability assessment:

- Mortgage interest
- Car leases
- California professional license

For example, if an individual deducts mortgage interest payments for California property on a Federal income tax return, the FTB may consider the interest paid as indicative of resident status. The FTB might then take a multiple of the mortgage interest and issue an assessment asserting unpaid tax liability without any taxpayer input. FTB agents have done the same thing for vehicle payments on automobiles registered in California, taking a multiple of the claimed deduction as a basis to make an assessment on a nonresident.

Other typical avenues for the FTB to claim jurisdiction to tax individuals who deem themselves to be nonresidents include anyone holding a California professional license, such as a lawyer or certified public accountant. Of course, real property with a California address is a frequent trigger to an FTB assessment.

Conclusion

The long list of factors to which the FTB looks in determining if an individual is a California resident can be confusing for most taxpayers. A tax professional can be a taxpayer's needed ally to help assess whether habits and activities give the FTB too much ammunition in making a residency claim. Proactively engaging a tax professional to either help minimize current contacts with California or to structure lifestyle activities going forward if a previous resident has moved out-of-state can often be the key to deflecting an aggressive FTB position that residency is involved.

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