Transcript for FTB Webinar – FTB Form 540NR – Non-Resident and Part Year Resident

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Good morning and welcome to today's webinar. My name is Connie Hughes and today I will be assisted by Kevin Coughlin. We will be discussing how to prepare a California Nonresident or Part-Year Resident Income Tax Return (FTB Form 540NR).

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Before we get started, let's talk about general housekeeping information.

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For the tax professionals attending today, due to limited FTB resources, this webinar will not qualify for Continuing Education Credits.

Side 4

Please be sure to make a note of the dial-in number and access code in your confirmation email. If at any time during the presentation you are disconnected, or cannot hear the audio, use these numbers to listen by phone.

Feel free to submit your questions at any time during the webinar. We will do our best to answer all questions at the end of the presentation or respond back to you after the webinar.

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Let's get started!

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Today's objectives include:

- Filing Requirements and Status
- Community and Separate Property Rules
- Income Sourcing
- Preparing Nonresident Returns
- Things to Remember for Part-Year Residents
- Military
- Self-help Tools

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Let's talk about Filing Requirements and Status.

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Generally, California nonresidents are required to file a California personal income tax return if they receive California source income and their income from all sources exceeds the threshold amounts for their filing status. California sourced income could also mean a source loss. The income thresholds are in the 540NR booklet and are adjusted for inflation, so use the booklet for the same tax year you are preparing.

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There may be other situations individuals may need to file a California income tax return. Review the bulleted lists under, "*Requirements for Children with Investment Income"* and "*Other Situations When You Must File*," for more information. If you meet one of the situations, you will need to file a California return even though your income is below the threshold.

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California conforms to the federal filing status requirements. Generally, individuals filing a California income tax return must use the same filing status as federal. However, there are three exceptions to the general rule, which are:

- Exception 1: A member of the armed forces or any auxiliary military branch.
    - If either spouse is an active duty servicemember or a member of an auxiliary military branch, they may use married filing separate or married filing joint for California even if they filed a joint return for federal.
- Exception 2: A partner in a registered domestic partnership.
    - Federal does not treat registered domestic partners as married; therefore, each partner would file their own return for federal. However, California requires them to file a married filing joint or married filing separate return, or
- Exception 3: A nonresident for the entire year and had no California source income.

Be careful when applying this last exception. Individuals domiciled in a community property state may share source income with their nonresident spouses.

Domicile is the one place:

- Where you maintain a true, fixed, and permanent home.
- To which you intend to return whenever you are absent.

This may be confusing so let's look at two examples to demonstrate.

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John is domiciled and a resident of New York. His wife, Marcia, is domiciled and a resident of California. She works in California earning W-2 wages. Because California is a community property state, 50 percent of her wages are allocated to John. Therefore, John has California sourced income even though he was never in California. They would have to use the same filing status as federal because one of the three exceptions was not met.

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Now let's change the facts in the first example. John and Marcia are domiciled and residents of New York, which is a separate property state. Marcia worked in California earning W-2 wages.

Because Marcia is domiciled in a separate property state, she would not allocate any of her income to John. Marcia would report all of her income if she filed separately from her husband for federal purposes. Marcia is a nonresident with sourced income, so she would have a California filing requirement. However, John is a nonresident with no sourced income, so he would not have to file in California. Therefore, the requirements of the last exception are met, and Marcia could use a different filing status for California.

I will turn the presentation over to Kevin.

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Thank you Connie. Let's look at the importance of community and separate property rules.

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Before we can apply community or separate property rules, we need to talk about domicile.

Domicile is the one place:

- Where you maintain a true, fixed, and permanent home.
- To which you intend to return whenever you are absent.

Only one state can be an individual's domicile and may or may not be the same state of residency. The state of domicile is used to determine how income is split between a married couple or RDP.

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When an individual is domiciled in a community property state, income must generally be split 50/50 with their spouse or partner. Individuals domiciled in a separate property state report all income earned or received; they don't share.

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States that follow community property rules are:

- Arizona
- California
- Idaho
- Louisiana
- Nevada
- New Mexico
- Texas
- Washington
- Wisconsin

Generally, all other states follow separate property rules.

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There are also U.S. Territories that follow community property rules, such as:

- Puerto Rico
- Guam, and
- The Commonwealth of Northern Mariana Islands

If your client is domiciled in a foreign country, you will need to do some research to determine how income is split.

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Generally, income earned or received by an individual domiciled in a community property state is community property. Examples of this income are:

- Compensation for services
- Retirement pay
- Interest and dividends
- Capital gain, and
- Any income from property held jointly regardless of domicile

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We have talked about filing requirements, filing status, and community and separate property rules. Now, it is time to discuss income sourced to California. It is important to determine sourcing before we determine if the income is taxable to California as a nonresident.

Let's look at income sourced to California.

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Generally, income with a connection to California, whether it is a direct or indirect connection, it is taxable to California regardless of residency. Let's talk about some common income reported by individuals:

- Compensation for services rendered is generally taxable to the state where the work is performed regardless of:
  - The location of the employer.
  - The location where the payment was issued, or
  - The individual's location when the payment was received.
- Tangible property is taxable to the state where the property is located.

- Gambling winnings are taxable to the state where the activity took place. If a nonresident wins at a California casino, they would pay taxes to California regardless of where they live. However, California state lottery is not taxable; it is excludable by California law.

- Intangible income is generally taxable to the state of residency. This includes selling your partnership interest or stock sales even if the business is located in California. However, intangible income would be taxable if it has a business situs. Go to R&TC §17952, for more information.

- Sourcing trade or business income can be a little tricky. You will need to apply the appropriate rules. Go to California Regulation §17951-4 for assistance.

Now, I will turn the presentation over to Connie.

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Thank you Kevin. We have discussed how income is allocated based on community and separate property rules and some income sourcing rules; we are ready to prepare a California nonresident return.

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Earlier we talked about how domicile determines how income is split. Now we will talk about how income is taxed.

California residents are taxed on all income from all sources and nonresidents are taxed on income only from California sources. Part-year residents are taxed on all income, regardless of source while they are a resident. Nonresidents are only taxed on income sourced to California. You would apply both requirements and add the results together to get California taxable income.

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It is important to identify who is a resident or a nonresident of California so the income is allocated to California properly.

A California resident is an individual who is:

- Present in California for other than a temporary or transitory purpose, or

- Domiciled in California but outside of California for a temporary or transitory purpose.

A California nonresident is any individual who is not a resident.

And

A California part-year resident is an individual who meets both resident and nonresident criteria.

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After determining if an individual is a resident or nonresident, you can determine which form to use.

- Residents of California would file a 540
- Part-Year or Nonresidents would file a 540NR

    - Keep in mind, if you have a married couple or registered domestic partners and one is a part-year or nonresident, a 540NR would be filed.

We have two 540NRs. The long form is for all situations and short form is for individuals that qualify. The 540NR short form can be filed by nonresidents, who:

- Use any filing status except for married filing separately
- Are not 65 years old or older
- Have 5 or less dependents
- Have less than $100,000 of total income
- Do not have adjustments other than military pay adjustment or unemployment,
- Does not qualify for the child and dependent care credit, or
- Has no 592 or 593 withholding

Because most tax preparation software does not support the 540NR short form, we will only be discussing the steps needed to prepare a 540NR long form.

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To prepare a 540NR, make sure you've completed your federal 1040 first. The federal AGI on line 37 of the 1040 must match line 13 of the 540NR. Now let's go over to the Schedule CA (540NR) to separate worldwide income from California income.

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The Schedule CA (540NR) is used to determine California taxable income by doing the following:

- Identify the domiciles and also, current and past residency information

- Enter the amounts of income and deduction reported on your federal return

- Adjust the income and deductions reported on your federal return for differences in California and federal law

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Also, the Schedule CA (540NR) is used to:

- Determine the portion of income reported on your federal tax return that was earned or received from California sources while you were a nonresident, and

- Determine your allowable standard deduction or itemized deductions

The Schedule CA (540NR) is the key in preparing the nonresident return correctly.

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Now let's work through an example on how the Schedule CA (540NR) works. Mr. and Mrs. Grasp were California nonresidents for the entire year. They are domiciled in a community property state. Mrs. Grasp works for a local retail outlet in her home state. During the housing crisis, she bought rental property in her neighborhood and placed it in service. The rental is in her name only and she is receiving rental income every month. Mr. Grasp is an engineer working for a local construction firm. His company sent him to California for two months to consult on a project. He returned home after the job was done. All other income they received is held jointly.

Assuming they are filing a joint return for federal, they would have to use the same status for California because they do not meet one of the exceptions discussed earlier. Mr. Grasp's domicile is a community property state and his wages for the time he worked here is sourced to California as a nonresident. He would split the income based on community property rules. Therefore, Mrs. Grasp would also have California sourced income based on her half of Mr. Grasp's wages.

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Let's assume Mr. and Mrs. Grasp has the following income:

- Wages totaling $110,000
- Joint bank interest $100
- State tax refund $450
- Capital gains $10,000, and
- Rental income $12,000

Their federal AGI of $132,550 would be reported on Line 13 of the 540NR. Now let's complete the Schedule CA (540NR).

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Part 1 of the Schedule CA (540NR) is informational only. Not all of the questions will apply to all taxpayers. Only answer the questions that are applicable to your situation.

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Part 2 Column A is a mirror image of the front page of the 1040. Do not make any adjustments in this column. Schedule CA (540NR), Line 37, Column A, must be the same figure as 1040, line 37. If not, there is an error.

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Columns B and C are for adjustments in law. One of the most common errors in completing a Schedule CA (540NR) is using column B and C to apportion income and deductions. Use these columns only to adjust federal AGI for California law differences. In other words, ask yourself if California tax law treats the income or deduction in the same manner as federal. If the answer is no, an entry is necessary. It is necessary to make an entry on line 10 subtracting out their state refund. California law does not include any state refunds in taxable income. Use FTB Publication 1001, for more information on other adjustment items.

Sometimes, column B and C totals are negative. This happens when income adjustments are less than the above-the-line deduction adjustments. If line 37 of column B or C is a negative number, follow the instructions for Line 37 totals in the booklet or form instructions.

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Column D is federal AGI based on California law as if they were a California resident for the entire year. It doesn't matter what state the income is sourced to. The total for column D is the result of column A minus column B, plus column C.

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Column E is for California sourced taxable income. A portion of Mr. Grasp's wages are in column E. The amount represents the income that was earned in California during his two month stay. One of the most common questions we get is how to allocate income to California. Sometimes, the employer or contractor will do it for you but most of the time it takes a little math.

In our example, Mr. Grasp was working in California for two months. He is paid an annual salary with his current employer of $75,000 a year. Generally, there are 365 days in a year. To apportion the salary earned while in California, you could divide the annual salary by the number of worked days to get the daily salary amount. Let's assume, Mr. Grasp's salary is $205 per day. Next, multiply the number of days worked in California. Based on our example, Mr. Grasp was in California for 60 days. The result of $12,300 represents California sourced income, which is reported in column E.

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Part 3 of the Schedule CA (540NR) is used to adjust the federal itemized deductions based on California law. We start by adding up federal Schedule A, lines 4,9,15,19,20,27, and 28. As stated earlier, California does not conform to every federal provision. In the case of itemized deductions, one of the most common adjustments is state and local or general sales taxes paid deduction. We do not allow the deduction for California so the deduction would be subtracted from the federal Schedule A amounts. The result of Part 3 is allowable deduction for California.

Finally, Part 4 is used to determine California taxable income.

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Once you complete the Schedule CA (540NR), you have done the majority of the work preparing a nonresident return. The actual 540NR form itself is generally just math. We start with the federal AGI, then make any adjustments based on California federal law differences, then calculate the tax as if you were a resident the entire year.

If you remember, we made an adjustment on the Schedule CA (540NR), line 10, subtracting out the state refund, which is entered on line 14 of the 540NR.

Also if Schedule CA (540NR), Line 37, column B is a negative number, it is entered in as a positive number on Line 16 and if Line 37, column C, is a negative number, it is entered as a positive number on Line 14.

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After calculating the tax on worldwide income, you would calculate the California tax rate by doing the following:

- Tax on total taxable income divided by total taxable income, or
- Line 31 divided by Line 19

The result represents the California tax rate. The California tax rate is multiplied by the California taxable income we determined on the Schedule CA (540NR), line 49. Thus, it is crucial that the Schedule CA (540NR) is correct. Also, if there is an error on the 540NR, more than likely it will be on the Schedule CA (540NR), so you should always verify the Schedule CA (540NR) amounts. Software **may** not prepare a California nonresident return correctly, so it is important to always double check your figures and not rely on the software.

Now I will turn the presentation over to Kevin.

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Thank you Connie. Let's discuss some things to remember when preparing a part-year resident return.

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California part-year resident return is a hybrid between resident and nonresident returns. Individuals use resident rules while they are a resident and nonresident rules while they are a nonresident. This can be a little confusing but column E of the Schedule CA (540NR) is used to report all the income that is taxable to California.

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Let's look at an example on how to determine what is taxable to California as a part-year resident. Sally's employer transferred her to their California branch as the new Vice President of Operations. Sally moved to California and started her new job on July 1. She plans to stay in California indefinitely.

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Sally received the following income:

- Wages of $65,000 and

- Bank interest of $100

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As we discussed earlier, wages are sourced where the work is performed and bank interest is sourced to the state of residency. Sally was a California resident for six months of the year; therefore, six months of her interest is sourced to California. Her W-2 should reflect wages paid while working in California and wages paid while in the other state. Sometimes, the W-2 just has one state listed so you would use a reasonable means to apportion. In this example, Sally worked for six months in California so you would need to divide the annual wages by 12 months and then multiply the result by 6, which represents the total wages earned in California. This method to allocate will only work if the individual is paid on a salary basis. If an individual is paid hourly, you will need to calculate based on hours worked in California. There is no definitive way to allocate income. The method used is based on the facts and circumstances.

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So far, we have discussed how to file a nonresident return for civilians. However, California has a high population of active duty military members that may be required to file a California return. Let's talk about special rules when filing a tax return for servicemembers and their spouses.

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There is a huge difference between Temporary Duty Assignments or (TDY) and Permanent Change of Station or (PCS) orders. TDY is a travel assignment at a location other than a permanent duty station and PCS is the official relocation of active duty military members and their families. The difference between TDY and PCS is important when servicemembers are domiciled in California.

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Servicemembers domiciled in California are residents while stationed in California on PCS orders. However, they are treated as nonresidents while stationed outside of California on PCS orders.

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Let's look at an example of a California domicile. Alex is domiciled in California and is stationed at Livermore Logistic Air Command, California. She was sent to North Carolina on TDY orders for training. The training will be approximately 2 months. Would she be treated as a nonresident while in North Carolina?

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No. In order for Alex to be treated as a nonresident, she would need to be transferred to North Carolina on PCS orders, not TDY.

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Now let's discuss how a California domicile would be treated if they come through California for training on their way to their new duty assignment. This is called TDY in route. It is very common for military members to come through California for additional training on their way to a new assignment. Let's look at an example of how to treat servicemembers that are in California for a temporary period of time.

Connor, a California domicile, is stationed at Wright Patterson Air Force Base, Ohio. He receives PCS orders to Andrews Air Force Base, Virginia to be an interpreter in Washington, D.C. The air force sent him to the Defense Language Institute in Monterey, California to learn Arabic before reporting to Andrews AFB. The school will be 179 days.

Will Connor be treated as a California resident while in Monterey?

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No. Connor is in California on TDY orders. In order for him to be treated as a resident, he would need to be in California on PCS orders.

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Now let's talk about servicemembers not domiciled in California. Servicemember Civil Relief Act prohibits us by law to make an active duty servicemember a California resident simply because he or she is stationed here on PCS orders if the servicemember is domiciled in another state. Therefore, the servicemember is a nonresident while present in this state and follow nonresident rules for tax purposes.

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Because servicemembers domiciled in a state other than California are nonresidents while stationed in California, their military pay is not California sourced income. However, they could have a second job in California. Income from the second job is taxable to California. Only their military pay is protected by the Servicemember Civil Relief Act.

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For tax years with open statutes as of December 19, 2003, we are not allowed to use the military pay of active duty servicemembers not domiciled in California to increase their tax liability or in federal AGI limitations on deductions, under R&TC §17140.5. This is referred to as the Military Pay Adjustment or MPA.

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MPA applies when:

- An active duty military member does not domicile in CA
- Military W-2 wages are excluded from federal AGI limitations, and
- Military pay is subtracted on the Schedule CA (540NR)

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Let's go over an example on how the military pay adjustment works. In 2013, Jason joined the army from Wisconsin. He went through basic training at Fort Jackson, South Carolina. After training, he was transferred to California on PCS orders. He got a second job at the Post Exchange. Would the military pay adjustment apply?

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Yes, Jason is domiciled in a state other than California; therefore, the military pay adjustment would apply with his active duty military pay but not his pay from the second job.

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This is how the Schedule CA (540NR) would look. Column A would be worldwide income, which includes Jason's military pay plus wages from his second job.

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Jason's military wages would be entered in Column B.

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His wages from his second job is the only taxable portion of his overall income for California.

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We have talked about how we treat active duty military income; now let's talk about a special rule for military spouses. Beginning with tax years on or after January 1, 2009, the Military Spouse Residency Relief Act, or MSRRA, protects military spouses from becoming a California resident or domiciled solely because he or she accompanies the active duty spouse. This act prohibits us from taxing earned income received by a nonmilitary spouse from services performed in this state if:

- The spouse is in California to be with the servicemember serving in compliance with military orders, *and*
- The servicemember and spouse have the same domicile in a state other than California.

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Let's look at an example of how to treat servicemembers and their spouses' income.

Jordan and his wife, Sara, are stationed at Edwards AFB, California. They live in base housing. Sara works at the Base Exchange as a sales representative and Jordan has a second job at the bowling alley in Lancaster, California. They are domiciled in Mississippi. How would their income be reported on the Schedule CA (540NR)?

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Jordan's military pay qualified for the MPA because he is domiciled in a state other than California. His military wages of $45,000 is subtracted out in column B, but Sara's income is included in the federal AGI based on California law because California law treats earned income in the same manner as federal and her income is not protected by the Servicemember Civil Relief Act. However, her income is protected by the MSRRA because Sara and Jordan are domiciled in the same state other than California and Sara is here to accompany her husband in compliance with military orders. Sara's income is included in the federal AGI based on California law but only Jordan's bowling alley income is taxed by California.

Now, I will turn the presentation over to Connie.

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Thank you Kevin. Let's talk about the self-help tools available for nonresidents and servicemembers.

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Our website has a lot of useful information. Go to the "Forms and Instructions" link in the middle of the homepage, under "File". You can locate any form or publication by type and year or by entering the publication or form number in the search box.

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You can also search our website for additional information by typing "*nonresident and part-year resident*" in the search box at the top of the page. The first link that pops up will take you to our nonresidents and part-year resident homepage. Here, you will be able to view information on:

- Determining your residency status
- Taxing residents, nonresidents, and part-year residents
- Determining if you need to file
- Which forms to use, and
- Other information useful to prepare a nonresident return

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Now it is time for questions. You can submit your questions through the "Ask Question" window on your Go To Meeting Dashboard.

Please note, that we will only be answering general questions. For account specific questions, please call the Tax Practitioner Hotline at 916.845.7057, Monday through Friday, from 8 a.m. to 5 p.m. Again, that number is 916.845.7057.

Depending on the volume of questions received, we may present a series of standard questions and answers.

If we cannot answer all of your questions within our allotted time, we will email you with the answer.

Our first question is:

1. How do I get a copy of this presentation?

   Answer: You can request a copy of this power point presentation and script through the question box on our dashboard. You may also visit our website within the next week to view a copy of this presentation and script online.

The next question is:

2. What form would a married couple file if one of the taxpayers is a resident and one is a nonresident?

   Answer: If they file married filing jointly, they would file a 540NR. You would apply the community and separate property rules to split their income. Income allocated to the resident would be taxed to California regardless of source and the income allocated to the nonresident would be taxed if the income had a California source.

We have another question, which is:

3. Can the state of domicile also be the state of residency?

   Answer: Generally, the answer is yes; however, it may not be. Individuals only have one state of domicile but may be a resident of more than one state.

The next question is:

4. How do I determine if I am a California resident or not?

   Answer: We have information on our website to assist you in determining if you are a California resident. FTB Publication 1031, *Guidelines for Determining Resident Status*, is also available.

We have time for one more question:

5. I have a client that is a California domicile but is stationed on PCS orders in Alaska. My client has California withholding reported on his W-2. How does my client receive his withholding back?

   Answer: He would file a 540NR return reporting zero California sourced income. The withholding will be refunded.

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That's all the time we have for questions today. If you would like to view this webinar or prior ones, please go to our website and click on "News & Events." Webinars is the third item listed on the left navigation bar.

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We hope you found this information interesting and helpful.

On behalf of the California Franchise Tax Board, thank you for attending today's webinar.