

## **Income Adjustments**

These are the adjustments available on the California Form 540. See the Form 540 section for more information and income adjustments available.

### **State Income Tax Adjustment**

California does not tax state income tax refunds. Enter the amount of any state income tax refund on Form 1040, line 10, as a subtraction adjustment to income on the California return.

### **Unemployment Compensation Adjustment**

California does not tax unemployment compensation or paid family medical leave reported on federal Form(s) 1099-G and shown on the federal tax return. Enter the amount of taxable unemployment compensation or paid family medical leave on Form 1040, line 19, as a subtraction adjustment to income on the California tax return.

### **Social Security Benefits, Tier I and Tier 2 Railroad Retirement Benefit Adjustments**

California does not tax:

- Social security benefits and equivalent tier I railroad retirement benefits on Form 1040, line 20b.
- Tier 2 railroad retirement benefits on Form 1040, line 16b.

Enter the total taxable amounts of the income types above on your client's federal tax return as a subtraction adjustment to income on the California return.

Adjust the income types above on California Adjustments – Residents Schedule CA (540) for Form 540 filers.

### **California Nontaxable Interest or Dividend Income Adjustment**

California does not tax interest income from:

- United States savings bonds.
- United States Treasury Bills.
- Any other bonds or obligations of the United States, U.S. territories, and government agency obligations specifically exempt by federal law.

Enter nontaxable interest amounts included on Form 1040, line 8a, as a subtraction adjustment to income on the California tax return. Adjust the income types above on California Adjustments – Residents Schedule CA (540) for Form 540 filers.

### **Interest from municipal or state bonds from a state other than California:**

Report this interest, taxable by California but not by federal, on Schedule CA (540). If you identify this type of interest income as tax exempt on your client's federal return, add it back on their state return. Enter the federal tax-exempt interest amount on line 8, column C, Schedule CA (540).

### **Exempt-interest dividends from mutual funds:**

Certain qualified mutual funds pay "exempt interest dividends." If at least 50 percent of their mutual funds, at the end of each quarter, consist of tax-exempt government obligations, including tax-exempt government obligations of the state of California and its' municipalities, that amount of dividend is exempt from California tax. Find the tax-exempt portion of the dividend on your client's annual statement. Enter the California exempt-interest amount that exceeds the federal exempt-interest amount on Schedule CA (540), line 8, column B.

Tax exempt interest dividends include:

- Exempt federal obligations, or
- California state or local obligations.

For California purposes, federal and California state obligations may be combined to meet the 50 percent test. California law on tax exempt obligations is different than federal. The differences are:

- Federal – State or local obligations of any state.
- California – California state or local obligations. U.S. federal obligations.

**Important Info:** The mutual fund determines the tax-exempt amount for federal tax purposes and sends a statement to the taxpayer. The federal amount will be correct for California if the exempt-interest dividends are from California state and local obligations.

Only federal obligations that would be exempt from California taxation if held by the individual taxpayer qualify for tax-exempt treatment.

The amount designated by the mutual fund as an exempt interest dividend may contain items that are not exempt from California tax (e.g. non-California state obligations or non-deductible interest expenses). In this case, only a percentage of the dividend will be exempt for California purposes.

## **California Distributions**

Although the taxing method of IRA distributions is generally the same for California and federal calculations, there may be differences in the taxable amount depending on the year the client made the contribution.

If your client or their spouse/RDP contributed to an IRA in 1975, or 1982 through 1986, you may need to make an adjustment. California and federal deduction rules differed during these years. The client may owe less California tax on the distribution amount.

Consider an IRA fully taxable if your client took the full deduction at the time of the contribution. If the IRA contribution was partially or fully nondeductible, then the nondeductible contribution is not taxed when your client begins taking distributions.

Since California law differs from federal law, complete the “IRA Adjustment Worksheet” in this chapter to determine California basis.

### **1975:**

IRA deductions were disallowed for California. Federal allowed an IRA deduction up to \$1,500.

### **1982 through 1986:**

California and federal law differed. The maximum federal individual deduction equaled \$2,000. Active participants in qualified and government retirement plans, and persons who contributed to tax-sheltered annuities, qualified for the federal deduction. For California, the maximum deduction was the lesser of \$1,500 or 15 percent of earned income with an additional deduction for a “nonworking spouse,” up to an overall limit of \$1,750. California disallowed all IRA deductions if an individual was an active participant in a qualified or government retirement plan or contributed to a tax-sheltered annuity.

### **1987 through present:**

California law generally conforms to the federal law. Therefore, if your clients made an IRA contribution during those years, no adjustment is necessary.

**California residents who were formerly nonresidents:**

California law changed for tax years beginning on or after January 1, 2002.

Before January 1, 2002, when your client became a California resident, they received a stepped-up basis in their IRA equal to fair market value at the time they became a resident. A nonresident's IRA basis was carried over until fully recovered. But now, under the new law, they no longer have this stepped-up basis.

On or after January 1, 2002, former nonresident are treated as if they were a resident for all prior years for all items of deferred income, which includes IRAs. Therefore, a former nonresident must recalculate their IRA under California law as if a California resident. This applies only to contributions made before 1987.

If your client became a California resident before 2002 with an unrecovered stepped-up basis carryover for 2002, restate their IRA basis using the new law.

If a client does not recover basis from the initial distribution, the client may amend for applicable years. Otherwise, any unrecovered basis is lost.

**Important Note:** For more information, see FTB 1005, *Pension and Annuity Guidelines*.

**Below is an example of how to figure a California Basis Adjustment**

<b>Basis Worksheets – Worksheet I Figuring California Basis/Adjustment to Federal AGI</b>	
<b>Part A - Pre-1987 California Basis</b> (If you have already computed your California basis as of 12/31/2016, or have always been a California resident, skip to Part B.)	
1. Enter your total federal deductions claimed prior to 1987.	
2. Enter total California deductions claimed prior to 1987 (or the deductions you could have claimed if you had been a California resident).	
3. Total California basis (subtract line 2 from line 1).	
4. Enter your California basis recovered in prior years.	
5. California basis as of 12/31/2016. Subtract line 4 from line 3.	
<b>Part B – Adjustments to Federal AGI and Remaining Pre-1987 California Basis</b>	
1. Enter your taxable distribution from your Federal Form 1040, line 15b (or line 16b).	
2. Enter your California basis as of 12/31/2016.	
3. Enter the smaller of line 1 or line 2. Enter this amount on Schedule CA (540), line 15b, or line 16b.	
4. Remaining California basis as of 12/31/2016. Subtract line 3 from line 2.	

<b>Enter Total California basis from information above or client's records:</b>	<b>1. \$900</b>
<b>Enter California basis recovered in prior years:</b>	<b>2. \$0</b>
<b>California basis as of 12/31/2016:</b>	<b>3. \$900</b>
<b>Enter client's taxable distribution from Form 1040, line 15b:</b>	<b>4. \$500</b>
<b>Enter client's basis as of 12/31/2016 (from line 3 above):</b>	<b>5. \$900</b>
<b>Enter the smaller of line 4 or line 5. Enter this amount on Schedule CA (540), line 15b:</b>	<b>6. \$500</b>
<b>Remaining California basis as of 12/31/2016, subtract line 6 from line 5:</b>	<b>7. \$400</b>

## Use this IRA Adjustment Worksheet to Calculate Your Client’s IRA California Basis.

**Worksheet II — Summary of California Basis**

Taxable Year	Pre-1987 Contributions	Deduction		California Basis in Contribution	Total Distribution	Federal Taxable Amount	California Basis Recovered	Remaining California Basis
		Federal	California					

### Contributions and Deductions by Year

Your client must be able to provide information to complete the chart in order for you to determine whether an adjustment is necessary. If your client does not have this necessary information, no adjustment can be made.

If your client can provide the necessary information, subtract total California Deductions (C) from total Federal Deductions (B). This amount is your client’s California basis. If there is no difference between B and C, there is no adjustment on Schedule CA (540), line 15.

### Basis of an Inherited IRA

Distributions from an inherited IRA are considered inherited income, not inherited property. The IRA basis is not stepped up to fair market value at the date of death. The beneficiary’s basis in the IRA is the same as the decedent’s basis in the IRA.

### California Pension and Annuity Adjustments

California and federal laws generally treat pension and annuity income the same. However, if any of the following apply, your client may have an adjustment on the California tax return:

- They receive a federal Form RRB 1099-R for tier 2 railroad retirement benefits and you included all or part of these benefits as taxable income on the federal tax return.

- They received a retirement annuity between July 1, 1986, and January 1, 1987, and elected to use the three year rule for California purposes. The federal taxable amount is less than the California taxable amount.
- They receive federally nontaxable foreign social security income.

**Standard and Itemized Deductions**

Your client deducts the larger of the standard or itemize deduction. Use the method that gives your client the larger deduction. Your client may itemize for state, federal, or both.

Clients over age 65, who take the federal standard deduction, may receive a greater state deduction if they itemize.

If your clients are married/RDP and filing separate tax returns, the client and their spouse/RDP must either both itemize their deductions or both take the standard deduction.

**The Standard Deduction**

If your client takes the standard deduction on their federal tax return, in many cases the state standard deduction will be greater than the allowable itemized deductions.

Any dependent, filing their individual tax return, must use the “California Standard Deduction Worksheet for Dependents” in this chapter.

**Line 6** – If your client completed the square on line 6, indicating possible dependent status on someone else’s tax return, complete the “California Standard Worksheet for Dependents” below.

1.	Earned income. For purposes of the standard deduction, earned income includes only wages.	\$400
2.	Enter \$350.	\$350
3.	Add line 1 and line 2.	\$750
4.	Minimum standard deduction (\$1,050 for tax year 2016).	\$1,050
5.	Enter the larger of line 3 or line 4.	\$1,050
6.	California standard deduction for the filing status.	\$4,129
7.	Allowable standard deduction. Enter the smaller of line 5 or line 6.	\$1,050