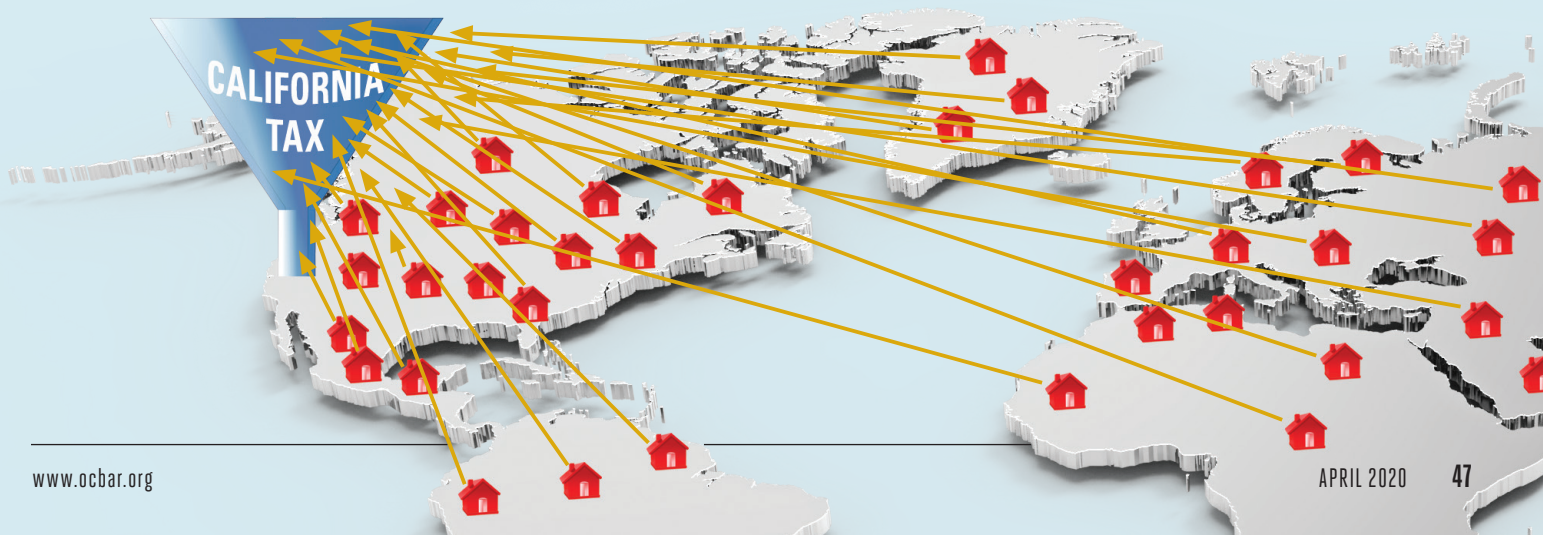
THE SUNSHINE TAX: CALIFORNIA'S INDIVIDUAL INCOME TAXATION OF NON-RESIDENT SERVICE PROVIDERS

by MATTHEW J. CARRUTH and DANIEL W. LAYTON

California provides wonderful benefits to its residents. Plentiful sunshine, temperate weather, warm beaches, snowy mountains, Disneyland and, at least for one author who lived for ten years in Washington, D.C., no bugs at night during summer months. On the other hand, California's 13.3% top marginal income tax rate is the highest of any state in the Union—contributing to the state's high cost of living, sometimes referred to as "the sunshine tax." Perhaps the old adage "where much is given, much is expected" explains why nearly forty million people continue to call California home despite the high taxes. But over the past decade, changes in California tax rules have subjected more taxpayers who never set foot in California to California taxes. This article provides a brief overview of the rules governing California's jurisdiction to tax income from services rendered by certain non-resident individuals either inside or outside of California.



A state's ability to tax non-residents is limited by the United States Constitution. In the seminal case of *International Shoe Co. v. Washington*, 326 U.S. 310 (1945), the United States Supreme Court held that an in-state suit to enforce payroll taxes could proceed against an out-of-state company because the company's in-state employees established sufficient minimum contacts and the suit did not offend "traditional notions of fair play and substantial justice" under the Constitution's due process clause. In *Complete Auto Transit v. Brady*, 430 U.S. 274, 279 (1977), the Supreme Court upheld Mississippi's "transaction privilege" tax on an out-of-state transporter delivering vehicles into the state, reasoning that a tax can survive a "Commerce Clause challenge when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state."

Like other taxing jurisdictions that impose taxes on net income, California may assert the right to tax net income earned by an individual taxpayer if either the taxpayer resides in California or if the income can be sourced to California. California taxes its individual residents on their worldwide income (i.e., no matter where the income is sourced), similar to how the United States taxes its citizens and residents. California taxes individual non-residents on their California source income. The rules for sourcing income for non-residents, provided at California Revenue & Tax Code (CRTC) sections 17951 to 17955, depend on the asset or activity from which the income is derived. The simplest application of this concept is where the source is California real property: A non-resident individual owning California real property would be liable for California income taxes on rental income from or the profits derived from the sale of that property. In other circumstances, the application of the rules is more complicated.

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Services Provided by Employees

The sourcing rules for wages and salaries paid to employees are generally based on where the services are performed. *See Appeal of Janice Rule*, 1976-SBE-099, October 6, 1976. Several exceptions apply, such as those for military personnel, airline employees, and truck drivers. If the non-resident employee is working remotely for a California-based company and never sets foot in California, the wages from those services are not subject to California income tax. However, if the employee performs services in California for even one day, the employee will be required to file a non-resident return with the California Franchise Tax Board (FTB) reporting an allocated amount of income. Where the employee's pay is based on sales commissions, the entire commission for a sale made while in California is subject to California taxes. Where the pay is based on time worked, the California-source allocation is computed using a ratio, with the work days (called "duty days") in California as a numerator and all work days in the year as the denominator. Cal. Rev. & Tax. Code § 17954; 18 Cal. Code. Regs. § 17951-5(b).

"Duty days" allocations have been litigated in several notable cases involving actors and athletes. In *Newman v. Franchise Tax Board*, 208 Cal. App. 3d 972 (1989), actor Paul Newman challenged the FTB's use of a lower denominator which excluded non-filming days. Siding with Newman, the California court of appeal found that the denominator included all contract days, including those where he was contractually required to be on call but not actively filming. In *Appeals of Garrison Hearst & Antonio Langham*, 2002-SBE-007 (Nov. 13, 2002), the State Board of Equalization ruled that performance-based, refundable bonuses paid to two 49ers football players were compensation for services which must be included in the computation of allocable income. In both cases, the contractual language was key in determining the California-sourced allocation.

Services Provided by Sole Proprietors

Compensation for services rendered in connection with the individual's trade or business (i.e., sole proprietorships or single-member LLCs not electing corporate tax treatment) may be subject to California apportionment rules. A business subject to the apportionment rules must apportion some of its net business income to California based on a formula that is intended to reflect the amount of the business's value that is attributable to California.

The formula that California now uses to apportion net business income to California for most taxpayers is based on the percentage of business "sales" (essentially, gross receipts)

that can be sourced to California. This formula is the so-called "single sales factor apportionment formula" and was required for most taxpayers with apportionable income for tax years beginning on or after January 1, 2013. Cal. Rev. & Tax. Code § 25128.7. The previous generally applicable apportionment formula also took the percentage of payroll and property located in California into account.

In connection with the change to single sales factor apportionment, California also adopted new sourcing rules (so-called market-based sourcing) for sales from services and intangible property. Market-based sourcing rules source income based on where the benefit of the services are received. Cal. Code Regs. § 25136-2. With respect to services, the previous rules generally sourced income to the place where the services were performed. Place of performance is used by the U.S. federal income tax code to source income from cross border services. 26 U.S.C. § 861(a)(3), 26 U.S.C. § 862(a)(3). Taken together, the single sales factor apportionment formula and market-based sourcing for services impose a greater California tax burden on non-residents who provide services to California customers. The rule changes are part of a global trend in tax law, including the United States Supreme Court's 2018 *South Dakota v. Wayfair* decision (585 U.S. ___ , 138 S.Ct. 2080) involving sales and use taxes, that is giving the jurisdictions where customers are located more taxing authority over cross-border activity. Indeed, it is now possible for a non-resident sole-proprietor to be subject to California income taxes on services income even if he or she never sets foot in California.

Non-resident sole proprietors are subject to the California apportionment rules if they are deemed to be "carr[ying] on a unitary business, trade, or profession within and without" California. Cal. Code Regs. § 17951-4(c). According to an opinion by the California Office of Tax Appeals (OTA) issued in 2019, the threshold of "carr[ying] on a unitary business, trade or profession within and without" California is relatively low. A single customer located in California may be sufficient. And unlike the "doing business" standard for the business entity income tax nexus (Cal. Rev. & Tax. Code § 23151), or the recently enacted changes to the California sales tax nexus rules (Cal. Rev. & Tax. Code § 6203), there does not appear to be *any sales threshold* that an individual's business must reach before it is conducting a business in California.

In *Appeal of Bindley*, 2019-OTA-179P, the FTB asserted that an Arizona resident owed California income taxes on $40,000 of income he received from writing screenplays for two LLCs based in California. The taxpayer argued that he was not subject to California income tax obligations with respect to this income because he performed all the work in Arizona. Unfortunately for this taxpayer, for the years at issue he was subject to the new market-based sourcing rules rather than the place of performance rules. The OTA found that he conducted a unitary screenwriting business both within California (where he had a customer) and without California (in Arizona where he performed the services). The OTA then applied the California single sales factor and market-based sourcing rules to determine whether the taxpayer had any business income that must be apportioned to California. There did not appear to be any dispute that the LLCs received the benefit of taxpayer's services in California where the LLCs were based. Having determined that the taxpayer was conducting a business inside and outside of California and that the taxpayer had sales in California, the OTA ruled that the taxpayer had business income that must be apportioned to California and ruled in favor of the FTB.

It should be noted that, to avoid double taxation, non-resident sole proprietors with in-state customers may get some relief from California income taxes by claiming an Other State Tax Credit on their California state income tax returns. Cal. Rev. & Tax. Code § 18002. The tax credit can be claimed for taxes paid to the residence state on the same income. Also, the non-resident sole proprietor may be able to argue that, even though the payor of compensation is based in California, the benefit of the services were actually received elsewhere. In *Appeal of Wood*, 2019-OTA-264 (nonprecedential), a non-resident taxpayer convinced the OTA that the benefit of the taxpayer's software design services was actually received by the California customer's customer, which was based in Canada. The FTB has promulgated complex regulations, which were amended in 2016, defining where the benefit of services are received. Cal. Code Regs. § 25136-2. The FTB continues to engage with the public on additional amendments.

Conclusion

California is heavily dependent on the personal income tax to fund its budget. Per the 2019-20 Governor's Budget Summary (available at www.ebudget.ca.gov), the individual income tax accounts for 68.8% of all California General Fund revenues in 2019-20, just over $100 billion total. High progressive tax rates don't seem to bother most Californians; California voters approved temporary increases in the top brackets in 2012 (by Proposition 30) and later extended the increase in 2016 (by Proposition 55) through 2030. But, while non-residents can be required to pay their fair share within the limits of the Constitution, non-resident businesses may also decide that the additional layer of tax compliance outweighs the value of California's marketplace. After all, Florida has sunshine too.

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