

CALTAX COMMENTARY: CALIFORNIA NEEDS A BRIGHT-LINE TEST FOR DETERMINING RESIDENCY FOR TAX PURPOSES

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“Where do you live?” This seemingly straightforward question has been the source of major contention between taxpayers and the Franchise Tax Board for many years, resulting in time-consuming appeals, exhausting searches for documents and witnesses, significant audit resources, and, in some cases, expensive litigation. It is time for the state to end the confusion by establishing a bright-line test for determining whether a person is or isn’t a California resident for income tax purposes.

Inventor Gilbert Hyatt’s recent federal civil rights suit against members of the FTB and the State Board of Equalization brought the residency issue back to the front burner, but the issue started causing headaches long before the dispute between Mr. Hyatt and the FTB began more than 20 years ago.

One of the most famous episodes occurred in 1974, when the FTB staff made headlines for determining that President Richard Nixon was not a California resident from 1969 to 1973 for purposes of income tax, although he was domiciled in San Clemente, was away for a temporary period, and claimed San Clemente as his residence for federal income tax purposes. The Assembly Revenue and Taxation Committee investigated and held a hearing on the matter.

In 1988, another residency case made headlines when the Senate Revenue and Taxation Committee held a hearing on the FTB’s actions in a dispute involving Beldon and Mildred Katleman. Although the Katlemans voted in Nevada, had greater business interests in Nevada (Mr. Katleman was president of the El Rancho Vegas Hotel and Casino) and belonged to many social clubs in Nevada, they maintained residences in both states, and the FTB found them to be California residents because they had a homeowners’ exemption on their California home. The BOE upheld the FTB on appeal, but the FTB then agreed to settle the case for three-eighths of the amount in dispute.

Residency and the sourcing of income also were major issues in the 1990s, when Congress stepped in to stop the FTB from taxing non-residents’ income from pensions earned from past jobs in California.

More recently, members of Indian tribes in California have been grumbling, claiming that the FTB is aggressively going after revenue by alleging that some tribal members do not live on their tribe’s reservation, and thus must pay state income tax. Some of these disputes have gone before the State Board of Equalization, and have raised issues such as whether registering a vehicle to an address on a reservation is acceptable evidence that the owner lives there.

In fact, vehicle registration often is mentioned during residency disputes, but not in a consistent manner. In many cases, the FTB asserts that registration of a vehicle in California is a strong indication that the taxpayer is a resident, and should pay California income tax. But in one of the tribal appeals in 2012 (*Appeal of James J. Martin*), the FTB staff testified to the BOE that registration of a vehicle to an address on a reservation was *not* considered evidence that the owner lived where the car was registered.

Voter registration and driver's licenses also are used as indicators of residency, but again, without consistency. In some cases, the FTB argues that a California driver's license and voter registration at a California address are proof of California residency, but in other cases, the agency rejects taxpayers' arguments that licenses and registration in other states prove they don't reside in the Golden State.

In two residency appeals heard by the BOE on the same day in August 2010 (*Appeal of Brent and Viki Lee Welling* and *Appeal of Christopher and Catherine Hadsell*), time spent in California was an issue. In the *Welling* case, the FTB placed significant weight on the fact that the couple spent more time in California than Nevada, where they said they lived, but in the *Hadsell* case, the FTB acknowledged that the couple spent more time in Nevada, but downplayed the significance of that fact.

In the Hyatt case, the initial issue was whether the inventor lived in California or Nevada for a period in 1991 and 1992, and thus whether his income from patent royalties during that period is taxable by California. While more than two decades have gone by since the tax years in question, the residency dispute still has not been resolved. It seems incontrovertible that it should not take 22 years to determine the residency of any taxpayer. In fact, Mr. Hyatt's federal suit, filed in early April, alleges that the delay has "irreparably prejudiced" Mr. Hyatt, as "material witnesses have passed away, memories of witnesses have faded, and documents relevant and important to Hyatt are no longer available."

While the facts of each case are unique, years of following residency appeals before the BOE and in the courts have convinced CalTax that residency issues should be addressed by a bright-line test, moving away from subjectivity and focusing on four key principles:

- **Fairness.** Californians expect their tax agencies to be vigilant against fraud, and indeed we benefit from ensuring that nobody dodges their tax obligations. But we also expect tax agencies to weigh evidence fairly, and to give documents such as state-issued licenses equal weight whether they support or refute a tax determination. The bright-line test should be fair and impartial, and should accurately determine whether a person is legitimately subject to California income tax.
- **Simplicity.** When he was a member of the BOE, Bill Leonard suggested that the state should consider creating a checklist of 20 or so possible residency indicators (ownership of property, voter registration, vehicle registration, etc.),

and that a taxpayer who checks a specified number of items would be considered a resident for tax purposes. The FTB already has a checklist for indicators of residency, but it isn't used as a bright-line test – rather, it is completely subjective, and the agency can assert that a person is a California resident even if most of the items on the list would indicate non-residency.

- **Certainty.** The test should leave no gray areas or room for “gotchas” – it should create certainty for the taxpayer that residency has been decided, and future audits and back taxes will not be an issue. A residency checklist should carry weight, and should include descriptions of what documentation will be honored to substantiate each item on the list, so taxpayers have the ability to obtain and retain documents that will be accepted by the FTB.
- **Avoid Negative Side-Effects.** One of the positive consequences of a bright-line test would be to improve California's competitiveness by eliminating the perception that tax agencies target any wealthy individual who sets foot in California. Other consequences could be negative, and must be avoided. For example, investing in California-based businesses, hiring California-based lawyers, visiting a California surgeon, putting money in California banks, etc., should not be considered indicators of California residency (as they sometimes are now – in the *Hadsell* case, for example, the FTB argued that the continued use of brokerage and insurance services in California was evidence of residency). Residents of other states should not be discouraged from contributing to California's economy. The state should not risk losing sales tax revenue, income tax revenue or jobs by discouraging people from investing, buying, or traveling in California.

A bright-line test also would address the very important principle of timeliness. When years go by between the beginning of a residency dispute and its conclusion, taxpayers are disadvantaged. The threat of growing interest can create financial upheaval, and valid arguments might be foreclosed simply because of the loss of witnesses and documentation needed to disprove claims made by the FTB, which has the benefit of a presumption of correctness.

It is possible that the federal government should be involved, as with the proposed Mobile Workforce State Income Tax Simplification Act, which is intended to standardize state income tax collection for travelling employees, and to create certainty about where wages should be reported.

The issue of residency has consumed more than its share of time and resources – for taxpayers, the tax agencies and courts alike – and it behooves us all to get together and find a simple, fair method of ensuring that the state taxes only those who legitimately owe California income tax.