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5 Unsettling California Tax Rules

If you live in California—or even if you don't—you probably know something about California taxes. They are high, the highest in the nation. And the state's tax man is aggressive too, way more aggressive than you might think. Think the IRS is tough? California's Franchise Tax Board is generally regarded as more uncompromising when it comes to tax disputes. What else should you know about California taxes? Consider these five things.

California Capital Gain Taxes Are Among the Highest in the World**.** With a top income tax rate of 13.3%, California taxes hurt. But one of the biggest complaints I hear is not about the top rate, it is about capital gain. With the IRS, the top capital gain rate is 20%. Add the 3.8% net investment tax under Obamacare, and you have 23.8% to the IRS. But do you get any kind of capital gain break in California?

Nope, Californian's pay up to 13.3% on their capital gain too. By paying 23.8% plus 13.3%, Californians are paying more on capital gain than virtually anyone else in the *world*. Those disproportionately high California taxes are an increasingly large share of the tax burden. It is one reason that California's 13.3% tax on capital gains inspires move then sell tactics. Moving to no-tax Texas, Florida, Nevada or Washington can look pretty good.

There are More Millionaires *and* Billionaires in California than *Anywhere* Else**.** Forget per capita rates and other statistics. California has more than a *million millionaires*! That is hands down more than any other state. But hey, the Golden State has more *billionaires* than any other state too. Yes, that means paying lots of California taxes.

If You Don't File a Tax Return in California, the State Can Audit You Forever. OK, maybe this isn't bizarre, but it's still important. If you don't file a California tax return, the state can come after you forever. The statute of limitations never runs. California can go back ten or even twenty years. If you want closure, one strategy is to file non-resident tax returns reporting just your California source income.

Some people intentionally generate some income in the Golden State (say a small rental property that produces a little rental income) just so they can file California tax returns. That gets the statute of limitations on audit running. And four years after you file a return in California, if the state has not audited, that year is closed. After that, California can't come after you, even if California says you were a resident. Why four years? The IRS normally gets three years to audit a tax return. California gets four years, one year more than the feds.

You Can Leave But You Can't Hide. The thought of leaving California over taxes is nothing new. California's tough Franchise Tax Board (FTB) monitors the line between residents and non-residents, and does so rigorously. If you leave, California is likely to probe how and when you left, and whether you *really* stopped being a resident. For that reason, even if you think your facts are not controversial, be careful. California is known to chase people who leave, and to disagree about whether they really are non-residents. There's good reason, California's 13.3% tax on capital gains inspires plenty of tax moves.

But be careful with timing. Even where California *agrees* that you moved, they might not agree *when* you moved. Say you move from California to Texas, and then sell your appreciated stock or bitcoin. California might *agree* that you moved, but might say you didn't actually establish residency in Texas and depart California for tax purposes until several months later. That might be enough to make all your sales California source income. It can make you wonder whether California will 'let' you move states! Some people seek to avoid California taxes with trusts.

Just *Dealing* With Californians Can Mean Taxes**.** This one is a shocker, even by California standards. California is sending tax bills to plenty of nonresidents who just *do business* with Californians. Consider gig economy workers who work remote, and many other people out there. Take the case of Blair S. Bindley, OTA Case No. 18032402 (May 30, 2019). He lived and worked in Arizona, writing screenplays that he sent to studios in California and elsewhere. Since some of his customers were located *in* California, the state said his business—which was just him—had to pay taxes in the Golden State.

The California Franchise Tax Board matched income records showing that he collected $40,000 of income from California companies. Not surprisingly, Bindley did not file a California tax return. That meant California's statute of limitations would *never* start to run. Bindley worked for himself writing and selling his scripts, and basically did the same kind of work for non-California and for California companies. California said his was a *unitary* business, which the state defines in the reverse. California's tax regulations only describe what is *not* a unitary business. California says that a business is not unitary where the part within the state is so separate and distinct from (and unconnected to) the part outside the state that the businesses are not a unitary business. Here, the Golden State said that this screenwriter ran a unitary operation.

If your business is unitary, the income derived from services is sourced to the place where the *benefit* of the service is received. To determine the place where the benefit of the service is received, California law provides rules looking first to the contract. If the contract does not specify the location where the benefit is received, then California or the taxpayer can try to approximate the location where the benefit is received. For the companies located in California that paid the screenwriter, California said it was reasonable to conclude that the companies received the benefit of the services in California.

Does this screenwriter's unfortunate tax flap mean *other* little businesses that happen to sell into in California could face tax troubles? You bet. California can now push even on sole proprietors who *might* have California customers. They might have to file California returns and pay California taxes. This is so even if all the services are performed *outside* of California, and even if the sole proprietor has no connection to California. But hey, the state seems to be saying, California needs the money...

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