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New Case Restricts California Taxing Residents Who Move Away



People move states for many reasons, but California's high cost of living and sky-high 13.3% taxes often are a reason. Whether the destination is a no-tax state like Texas, Nevada, Wyoming or Florida, or any state with a more modest state tax rate than California's 13.3%, people are likely to pay lower taxes elsewhere. However, if you aren't careful when and how you move, you could end up in a residency audit with the California Franchise Tax Board.

Suppose you are terminated by your California employer, you and sue for wrongful termination. Let's say you move out of California hoping to leave the states taxes behind before your lawsuit settles. Nearly all wrongful termination and other employment cases are settled with a portion of the settlement treated as wages and reported on Form W-2. There are many tax issues in employment suit settlements, but some of the settlement is likely to be wages. A common percentage of the settlement to be treated as wages is 50%, although it all depends on the facts, and on the flexibility of the employer.

Tax on Severance Pay

But which state's taxes will be withheld? If you were a California employee, you were set up to have California taxes withheld, and most employers stick to this rule, even if you moved out of state and have been living out of state for years before you case settles. Up to now, the employers have also had support from California's Franchise Tax Board, which understandably preferred to have your pay sourced to California.

Helpful New Tax Authority

However, a new case from California's Office of Tax Appeals has cut back on the Franchise Tax Board's ability to tax non-California residents. In *Appeal of J. Otting and Y. Otting* (2026-OTA-403P), a precedential decision, the

California Office of Tax Appeals (OTA) cut back sharply on the state's practice of taxing income long after a resident departs.

Because true severance pay (rather than claims for back pay) is to sever the employment relationship, the OTA ruled that severance pay is income from an intangible asset (the employment relationship/contract), and it is therefore sourced to the residence of the former employee as of the date the severance is paid. Previously working in California does not give the employment relationship (the intangible asset) a California situs.

How About Restricted Stock Unites (RSUs)?

In the ruling, the OTA distinguished between a true severance payment and RSUs, which were also at issue in the audit. The OTA ruled that the RSUs were deferred compensation for work previously performed in California, so California could tax those even after the person left California. But severance was different, and even though severance pay is wages for income and employment tax purposes, the OTA said the severance pay was not wages for California *sourcing* purposes.

The OTA noted that the taxpayer didn't need to be paid the severance to compensate him for the previous work he did while in California. After all, that was what the salary he received while he was an employee was for, and what the RSUs were for. The severance must be compensation for something else, and that would be the termination of his employment relationship and a release for claims for *future* wages.

Future Wages in California

The OTA does say that if his future wages would have been *required* to be performed in California, the severance may have acquired a California situs, and would therefore still be California income even though it is income from an intangible asset. However, because the taxpayer in the case testified that his job would have also involved him working *in part* from outside of California (even if most of his work would have been in California), that was sufficient for the OTA to rule the claims being released for future wages did not acquire a California situs for sourcing purposes, so they would be sourced to his residence as of the date of payment.

Nevertheless, this reasoning suggests that if your work *would* necessarily be 100% within California (e.g., a California school teacher, or someone hired to work at a store that only has one physical location, located in California), a severance payment *could* still be California-source income because the *future* wages being released would have a California situs under those facts.

Stock Options and Other Equity-Based Compensation

How do moves impact stock options and similar equity-based compensation? You might assume that once you are living in a new state, you are safe from California taxes. Unfortunately, it's not that simple, since California often taxes options and restricted stock even after you move.