PERSPECTIVE

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Pay California Tax Even if You Never Set Foot in the Golden State

By Robert W. Wood

Most Californians know that the state's tax agency, the Franchise Tax Board or FTB, seems tougher than the IRS. Even if you live somewhere else, you might have heard of the Golden State's aggressive tax rules and fearsome tax collector. If you owe the IRS and the FTB, it is usually a lot easier to resolve your case with the IRS. Californians also know that if you move out, the FTB may chase you, sometimes for years. Residency fights with the FTB are notorious. The state may say you never left, or if it's undeniable that you really did leave for good, the FTB may argue about *when* you left.

Say you left a few months before you sold your stock or cash of crypto. The FTB may argue you that were still a tax resident when you sold. Buy a vacation home in California, and stay a little too long? Come into the state and do some work for your non-California employer? It can seem like *any* connection to California can be enough to get taxed there. But can you *truly* be outside of California—always—and *still* face California taxes? Yes, several recent decisions say you can.

In the Matter of Blair S. Bindley, OTA Case No. 18032402 (May 30, 2019), a sole proprietor performed all of his services *outside* of California, but some of his customers were in California. Is that enough for the poor guy to attract California tax liability? The California taxing authorities said he was operating a "unitary" business. Therefore, his tiny business was subject to California's apportionment rules.

The FTB would not budge, so Mr. Bindley went over their head to the state's Office of Tax Appeals (OTA), but it agreed with the FTB. This case has precedential effect, so it is clear that the Golden State can go after other non-Californians too, and it's happening. Exactly what was poor Mr. Bindley's tax offense in California? He is a self-employed screenplay writer living in Arizona. He performed services for a few companies headquartered and registered in California.

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. That itself is a useful lesson. The statute of limitations is a reason that many non-residents of California file a return to report a small amount of California source income.

In Bindley's case, the state noted that whether a nonresident is subject to California's rules for apportioning income depends on: (1) whether the taxpayer is carrying on a trade or business within California, outside of California, or a combination thereof; (2) the type of entity conducting the business; and (3) whether the business is unitary. California ruled that Bindley's screenwriting business was carried on inside and outside of California. He worked as a proprietor, and basically did the same kind of work for non-California and for California companies. That's a useful lesson too.

What exactly is unitary anyway? California's tough 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.

After all, the part conducted inside California and the part conducted outside the state were not separate and distinct so as to be separate businesses. 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? Yes, it does. 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. Poor Mr. Bindley isn't the only one either. California OTA just decided another case, *Appeal of Bass*, 2022-OTA-145, involving a Tennessee sole proprietor who provided consulting services to a California insurance agency by Skype and phone. He *never set foot in* California, but the state ruled that he had to pay California taxes no matter what.

Mr. Bass argued that his case was different from the *Bindley* case because Bindley had produced a tangible product, a screenplay for a California customer. Bass was just consulting, not selling anything but his time. But the FTB and the OTA said otherwise. In fact, any time you are doing anything from someone in California, you should think about taxes and whether the state can track you down. One big way is if you get an IRS Form 1099-NEC from a California-based company.

Bottom line, try to always be looking over your shoulder for California taxes. Many Californians don't have a choice, but many leave. The thought of leaving California over taxes is nothing new. California's tough FTB polices the line between residents and non-residents and does so rigorously. If you leave, California is likely to probe how and when you 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.

After all, California's 13.3% tax on capital gains inspires plenty of tax moves. Even where California agrees that you moved, the timing can be a big point of dispute. 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. Ouch.

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