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7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **ROBIN LAKE**¹) Case No. 480267
13)

14 Year Proposed
15 2005 Assessment²
16 \$1,118

16 Representing the Parties:

17 For Appellant: Robin Lake
18 For Franchise Tax Board: Maria Brosterhous, Tax Counsel

20 QUESTION: Whether respondent properly included and calculated appellant's foreign source
21 income for purposes of computing appellant's rate of taxation under subdivision
22 (b) of Revenue and Taxation Code (R&TC) section 17041.

23 HEARING SUMMARY

24 Background

25 Appellant timely filed her 2005 California tax return reporting \$29,978 in total wages and
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27 ¹ Appellant resides in Los Angeles County.

28 ² Respondent should be prepared to provide a revised interest calculation as of the Board Hearing date.

1 omitting \$43,232 in wages earned while appellant was employed by Walt Disney Company Limited in
2 London. Upon receiving federal information showing the omitted wages, respondent issued a Notice of
3 Proposed Assessment (NPA), treating appellant as a California resident for all of 2005. Appellant
4 timely protested the NPA contending that she was only physically present in California for the last three
5 months of 2005. Respondent accepted appellant's position and changed appellant's 2005 residency
6 status to that of a part-year resident and asserted tax solely on appellant's California source income.
7 Respondent issued its Notice of Action on January 7, 2009, on this basis. This timely appeal followed.

8 Contentions

9 Appellant's Contentions

10 Appellant contends that it is unfair to compute her tax rate based on her total 2005
11 California source and foreign source income. In doing so, appellant believes that California is now
12 overtaxing her.

13 Appellant also contends that she used an inaccurate currency exchange rate to calculate
14 the value of her 2005 foreign earned income. Appellant contends that she originally used the exchange
15 rate as it applied on the day she prepared her taxes (£1=\$1.94, as she reported on her federal return).
16 Appellant contends that this amount was exempted at the federal level, so she was not particularly
17 concerned with whether this amount was an "accurate representation of what this income was worth in
18 US dollars." (Appellant's Appeal Ltr. at p. 1.) Appellant contends that the exchange rates between the
19 United States and Britain fluctuated throughout 2005 and the years thereafter. Appellant contends that a
20 more suitable measure of computing her foreign source income would be to use the Purchasing Power
21 Parity rate (hereafter the Parity rate), because it takes into account the higher cost of living and adjusts
22 for it as though all income was spent locally. Appellant contends that the Parity rate reflects ability to
23 pay better than the exchange rate. According to appellant, the Parity rate for 2005 according to the
24 Organization for Economic Cooperation and Development shows that \$1 was equivalent to 0.65 British
25 Pence so the "true value" of her British earnings would be \$34,285. (Appellant's Reply Brief at pp. 1-
26 2.)

27 Respondent's Contentions

28 Respondent contends that California does not conform to the federal exclusion for foreign

1 source income. Respondent contends that for part-year residents receiving income derived from
2 California sources, the California method of determining the tax requires the following steps:

- 3 1. Determine total worldwide adjusted gross income (AGI);
- 4 2. Subtract applicable deductions;
- 5 3. Determine the applicable tax rate based on the amount derived in step 2 (hereafter referred to as
6 the applicable tax rate);
- 7 4. Calculate California AGI, i.e., income derived from California sources;
- 8 5. Multiply the amount derived in step 4 by the tax rate determined in step 3. (This five step
9 process will be referred to hereafter as the California Method).

10 Respondent indicates that for calculating appellant's California source income in step 4, it
11 limited California income to appellant's wages earned while appellant was living in California (Los
12 Angeles). Respondent contends that the California Method was upheld by the Board in *Appeal of Louis*
13 *N. Million*, 87-SBE-036, May 7, 1987 and *Appeal of Dennis L. Boone* 93-SBE-015, Oct. 28, 1993.

14 Respondent contends that appellant initially reported foreign income of \$43,232 on her
15 2005 federal return. At protest, respondent agreed that the \$1.94 exchange rate was incorrect and
16 modified the exchange rate using the average 2005 exchange rate of \$1.82 as provided by the Internal
17 Revenue Service's (IRS) website. (*See* Resp. Opening Br., Exhibit H.) Respondent contends that the
18 IRS generally advises taxpayers reporting income earned abroad (other than income from specific
19 transactions) to use the yearly average exchange rate (hereafter referred to as the IRS rate). (*See* IRS
20 Publication 4732 "Federal Tax Information for U.S. Taxpayers Living Abroad" at p. 1, included in Resp.
21 Opening Br., as Exhibit I.) Respondent believes the IRS rate provides a fair measure of appellant's
22 foreign source income and believes the IRS rate is preferable to appellant's Parity rate. Thus, for
23 purposes of steps 1-3, respondent contends the IRS rate should be used.

24 Applicable Law

25 The California personal income tax is imposed on the entire taxable income of every
26 resident of this state, regardless of the source of the income. (Rev. & Tax. Code § 17041 subd. (a).)
27 When taxpayers have not been residents for the full year, they are nevertheless subject to California tax
28 on their entire taxable income received during the portion of the year in which they were residents.

1 (*Appeal of Jess O. and Marguerite M. Tush*, 63-SBE-042, Mar. 19, 1963.) R&TC section 17041,
2 subdivision (b) provides that the rate of tax on the income of a nonresident or part-year resident is based
3 on the taxpayer's entire income, including income that was earned outside of California. This tax rate is
4 then applied to California-source income. This approach was upheld by the Board in *Appeal of Dennis*
5 *L. Boone, supra*.

6 STAFF COMMENTS

7 The California Method used by respondent pursuant to R&TC section 17041, subdivision
8 (b) to calculate appellant's California tax rate (using appellant's California and non-California source
9 income) appears to reflect long-established law in California. Accordingly, at the oral hearing appellant
10 should provide support to show that respondent failed to correctly apply the law in her case.

11 As for steps 1-3 of the California Method, discussed above, appellant calls into question
12 what her foreign source income should be. This contention would affect the amount arrived at in step 1
13 and then affect the rate to be used under step 3. Since the tax rate for part-year residents is based on
14 their entire income, it follows that foreign source income has to be calculated. It appears to Board staff
15 that any exchange rate methodology designed to convert a foreign currency to the U.S. dollar may be, by
16 definition, a valuation methodology. Valuations are typically a question of fact, unless a mandatory
17 valuation methodology is provided for under the law. Since R&TC section 17041, subdivision (b) does
18 not appear to provide for a mandatory valuation methodology (i.e., some sort of mandatory exchange
19 rate mechanism), what appellant's foreign source income amount for 2005 should be appears to be a
20 question of fact for the Board to decide.

21 As stated above, respondent's factual findings are presumed correct, unless rebutted by
22 appellant. Accordingly, at the oral hearing, appellant should be prepared to rebut respondent's factual
23 finding. In doing so, the parties should be prepared to discuss the merits of their respective rate
24 methodologies (i.e., their currency valuation methodologies). From Board staff's perspective, it would
25 appear that using the IRS rate would promote conformity between respondent and the IRS when valuing
26 income earned outside of the U.S. (i.e., foreign source income). This valuation conformity would also
27 lead to uniform foreign source "income" amounts within a particular tax year for federal and California
28 purposes. Board staff is unfamiliar with the tax policy and valuation benefits associated with the Parity

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1 rate method. Accordingly, at the oral hearing, appellant should be prepared to discuss these benefits and
2 show why her valuation methodology (the Parity rate methodology) resulted in a better representation of
3 dollar income in 2005 than respondent's IRS rate methodology.

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