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# NONRESIDENTS WORKING REMOTELY FOR CALIFORNIA BUSINESSES

By Chris Manes

How to Take Paul Newman's "The Sting" Out of Your Taxes

With the rise of the internet, cloud and smart phone economy, more and more people have the option of living in one state while working in another – remotely. The possibilities for reducing state income taxes through this scenario haven't been lost on savvy hi-tech employees and business owners in California. By simply moving across state borders and working for a California business (or even running it) through the internet, they become nonresidents, potentially free of California's high income tax rates, while still being able to participate in California's thriving economy.

Of course this situation isn't lost on California's taxing authorities either. Because of that "remote workers" need to be careful and understand the tax rules for nonresidents working for California firms.

Generally if you work in California, whether you're a resident or not, you have to pay income taxes on the wages you earn for those services. That's due to the "source rule": California taxes all income with a source in California. And for tax purposes, the source of income from services is the location where the services are performed. This is true even if you are a nonresident, even if the contract with the employer is made out-of-state, and even if the wages are paid outside of California.

You can imagine how important the source rule is for California's taxing authority, the Franchise Tax Board, when it comes to actors and athletes. When LeBron James travels to California to play the Clips at Staples Center, California gets a cut of his pay for that night.

But what if the employee is a nonresident who doesn't have to set foot in California to perform his services? Then the source rule works for the nonresident. Remember, the source of the services is

the location where the work is actually performed. A nonresident programmer who monitors and upgrades satellite dish software for a Los Angeles-based media company, all while sitting comfortably in front of his computer in his Austin, Texas condo, doesn't earn California source income and doesn't have to pay California income taxes.

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At the employer end, while California companies have to withhold state payroll taxes for resident employees wherever they perform their services, and for nonresident employees for services in-state, not so for nonresident employees who perform services outside of California. This is true, by the way, even if the employee is a nonresident corporate director (or an LLC manager or general partner) and is paid for his work directing the company – as long as he only participates remotely (though don't confuse this with profit distributions to nonresident owners, which follow different rules I will address in a separate article).

So far so good. But what if a difficult glitch arises requiring the programmer to fly to Los Angeles to fix the system on site? Then everything changes. The source rule kicks in against the employee. In that case, just like LeBron James playing at Staples Center, or Paul Newman (who was a resident of Connecticut) making a movie in Hollywood, California taxes the income from those in-state services. What the FTB does then is to use an allocation formula based on "duty days" – the days the employee is present in California and working – in proportion to total work days.

The reason I mention Newman, by the way, is that he prevailed in a famous case against the FTB for his performance in "The Sting." Newman was able to show that the duty days formula should be based on what his contract actually required for working in and out of California, rather than the FTB's own calculation of duty days. Paul L. and Joanne W. Newman v. FTB (1989) 208 Cal. App. 3d 972. That's why it's very important to have a written employment contract that clearly states what obligations an employee has to work in California and what constitutes such work. Experience suggests that most nonresident remote employees at some time or other will have to travel to California to perform some services on site.

Note also that it's easy for LeBron James to prove how many days he worked in California and how many days he worked outside of California. You just have to look up the NBA schedule. It's not that easy for our programmer or other nonresident workers who perform services from their living room computers. Therefore, scrupulous record keeping and detailed employment contracts are a necessity.

So here are the caveats for nonresidents working remotely:

First, the entire favorable tax treatment of working remotely is based on the assumption that the employee is truly a legal nonresident. For employees who move from California to a lower tax state like Nevada or Texas, it's important they follow residency rules and genuinely change their legal residency. If they don't make the necessary changes to reduce or eliminate their California contacts, they may find themselves in a nasty residency tax audit.

Second, make sure to have a written employment contract that spells out the services to be performed out of state and in state, if any. In this way you are in control of the "duty days" allocation, not the FTB.

Finally, if any work is required on site (and it almost always will be at some point) keep good records of your work both in and out of state. This will allow you to make the most of the "duty days" formula allocation.

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**34100 Gateway Dr #100**
**Palm Desert, CA 92211**