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7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**
9

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **TODD BENTLEY AND KATE BENTLEY**) Case No. 593582
13)
14)

	<u>Year</u>	<u>Proposed Assessment of Additional Tax</u>
	2004	\$132,041
	2005	\$206,508

18 Representing the Parties:

19 For Appellants: Robert J. Chicoine, Esq., Chicoine & Hallett, P.S.¹
20 For Franchise Tax Board: Natasha Sherwood Page, Tax Counsel III
21

22 **QUESTION:** Whether appellants have shown that respondent (Franchise Tax Board or FTB)
23 erroneously assessed additional tax based on the sourcing to California of payments
24 related to appellant-husband's settlement of a lawsuit with his employer.²
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26 ¹ The appeal letter was filed by appellants on their own behalf. Robert Chicoine of Chicoine & Hallett subsequently filed an
27 opening and reply brief on behalf of the taxpayers.

28 ² For simplicity, references to "appellant" herein shall refer to Todd Bentley. However, he and Kate Bentley filed a joint
return and are both parties to this appeal.

1 HEARING SUMMARY

2 Background

3 In 1998, appellant moved from Canada to California. Appellant is a Canadian citizen and
4 former employee of the Canadian post office, and has an expertise in the international mailing industry.
5 When appellant moved to California, he worked out of a home office as a commissioned sales
6 representative for Great White North Ltd. of Livonia, Michigan, a package delivery company. The
7 company was partially owned by Global Mail Ltd., who was eventually acquired by Deutsche Post and
8 merged into Deutsche Post Global Mail (DPGM). (Appeal Letter (AL), p. 2, App. Op. Br., p. 2.)

9 In June of 2000, appellant entered into an employment agreement with Global Mail Ltd.
10 that provided the terms to govern his position as the Director of Strategic Accounts, Western Region.³
11 (App. Op. Br., pp. 2-3 and Exhibit B.) Pursuant to the agreement, appellant was paid a commission on
12 the gross margin of each completed mailing for which he quoted the customized rate, as well as
13 additional bonus commissions called “kickers” if he met his sales goals. (*Id.*) Appellant solicited
14 companies for international mailing business related to advertising and parcel mail orders. (App. Op.
15 Br., p. 2.) In addition to preparing proposals and customizing quotes, appellant also provided ongoing
16 customer service to his clients. Appellant worked directly with DPGM headquarters in Virginia from
17 his home office in California. (AL, p. 2.)

18 In March 2001, appellant was part of the DPGM sales team that secured a two-year
19 agreement with Amazon.com (Amazon) to provide Amazon’s international mailing needs. (App. Op.
20 Br., p. 3.) At that time, Amazon was DPGM’s largest client and accounted for a significant part of the
21 company’s overall revenue. (App. Op. Br., p. 4 and Exhibit 1.) At the request of Amazon, appellant
22 became the exclusive contact for all business with DPGM and its subsidiaries and communicated with
23 them on a daily basis and met with them monthly in Seattle. (AL, p. 3, App. Op. Br., pp. 3-4, Exhibit
24 H.) Appellant worked on the Amazon account from March 2001 until April 2003 servicing the account
25 including quoting rates for mailings, managing the flow of parcels, incident follow up, and preparing
26 reports. (App. Op. Br., p. 3) In early 2003, appellant was involved in the negotiations to obtain another
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28 ³ The agreement entered into was terminated in April 2003.

1 two-year agreement with Amazon. (App. Op. Br., Exhibit 1.)

2 In March 2001, appellant and DPGM mutually agreed to amend appellant's employment
3 agreement to reduce his base commission on the account from 13 percent to 6.5 percent. (App. Op. Br.,
4 p. 4.) Appellant understood that the revised agreement retained the kicker part of his commission on all
5 of his accounts, Amazon included. (App. Op. Br., p. 4, Exhibits D and E.) Although he originally
6 received the additional bonus payments in the second quarter of 2001, appellant did not receive the
7 payments in the third quarter of 2001 and a dispute ensued over the unpaid commissions.⁴

8 Appellant filed suit against DPGM in Los Angeles Superior Court on April 3, 2003,
9 alleging a number of complaints.⁵ (App. Op. Br., p. 5, Exhibit L.) DPGM asserted 16 affirmative
10 defenses and filed a countersuit alleging that appellant should reimburse the company for overpayments
11 of commissions due to costs not being charged against the gross margin for the Amazon account.
12 (App. Op. Br., p. 6, Exhibit N.) On April 11, 2003, just after appellant filed the lawsuit, the company
13 cancelled the employment agreement at the center of the litigation and rehired appellant as an at-will
14 employee.⁶ In 2004, appellant's sales territory was restricted by DPGM. (App. Op. Br., p. 5.)

15 While the lawsuit was still pending in August of 2004, appellant and his wife left
16 California and relocated to Vancouver, Washington. (App. Op. Br., p. 5.) Still employed by DPGM,
17 appellant continued to work on his accounts from his new home office in Washington. On November 2,
18 2004, pursuant to an arbitration agreement, appellant and DPGM settled the lawsuit and communicated
19 the settlement to the court.
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21
22 ⁴ The company indicated that it believed that securing the Amazon account was a team effort. (App. Op. Br., p. 5.) After an
23 analysis of the accounts, the company offered appellant a maximum of \$196,765 in commissions, and a \$5,000 monthly
24 salary for the responsibility of the Amazon account. (App. Op. Br., p. 5.) Appellant declined the offer.

25 ⁵The complaint alleged a number of causes of action including: unpaid wages, breach of written contract, breach of implied
26 covenant of good faith and fair dealing, negligent misrepresentation, conversion, fraud, accounting, and constructive trust. In
27 April of 2004, appellant filed a second amended complaint which added additional causes of action of retaliation and
28 negligence per se. (Resp. Op. Br., Exhibit D.) Appellant first filed a complaint with the California Labor Commissioner.
(Resp. Op. Br., p. 3, Exhibit D p.7.)

⁶Effective May 16, 2003, the company terminated appellant's original employment contract and made him an at-will
employee. The new agreement provided that appellant would no longer work on the Amazon account. (App. Op. Br., p. 5,
Exhibit O.) The company was able to negotiate a subsequent Amazon agreement without appellant's involvement in the
negotiations in the spring of 2003.

1 The Confidential Settlement and Release Agreement (Settlement Agreement) provided
2 that appellant’s employment with DPGM was terminated effective November 2, 2004. Appellant
3 received \$7,500 for alleged commissions, “separate and apart from his claims in the Action” and “in
4 addition to any amount to which he [was] already entitled.” (App. Op. Br., Exhibit S.)

5 The Settlement Agreement provided that for a total payment to appellant of \$5.3 million,
6 the parties would “discharge, compromise, settle, and resolve all of the claims in the Action and
7 cross-action and any other claims or causes of action that they may have or claim to have against each
8 other and agree as an essential and fundamentally material part of this Agreement that [appellant] will be
9 bound by the nonsolicitation provisions described.”⁷ (App. Op. Br., Exhibit S.) The nonsolicitation
10 provision in Section 13 of the agreement provided that appellant would not recruit employees or
11 independent contractors of DPGM for one year and would not solicit DPGM customers for six months,
12 excluding appellant’s five major clients, and a recital to the agreement indicated that this provision was
13 “essential and fundamentally material part of this Agreement that Bentley will be bound by”⁸

14 The agreement further provided in Section 4 that the portion of the payments at issue in
15 this appeal⁹ would be reported on IRS Form W-2 and that “part of the consideration the Company is
16 providing to Bentley under this Agreement is for the satisfaction of all claims made by him, including
17 for alleged past and future lost wages.” It stated that appellant represented he had a good faith,
18 reasonable basis for asserting Washington residency and that “the Company understands . . . that
19 [Bentley] will apply for a refund with the California Franchise Tax Board base on his belief that the
20 Company will over withhold California state taxes” In Section 5 of the Settlement Agreement,
21 appellant agreed to indemnify the Company from any tax incurred as a result of relying on his Form
22 W-4.

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24 ⁷ In addition to settling all the complaints from the lawsuit, appellant gave up his right to any future employment with DPGM
25 or affiliated companies and signed a Supplemental Release Agreement giving up all claims under the federal Age
26 Discrimination in Employment Act of 1967, as amended. (App. Op. Br., Exhibit S.)

27 ⁸ The clients excluded from the non-solicitation were: Primedia, Fredericks of Hollywood, Princess Cruise Lines, National
28 Pen and Affinity Group. (App. Op. Br., Exhibit S.)

⁹ As noted below, \$1.28 million was paid directly to appellant’s attorney and reported on Form 1099. Respondent’s
assessment does not include this amount, which respondent states was an error on its part. (See Resp. Op. Br., Exhibit L.)

1 The Settlement Agreement was finalized on December 17, 2004. Appellant provided
2 DPGM with a new Form W-4 and a declaration of his Washington residency. The payment was issued
3 as follows: \$3,000,000 was paid in December of 2004 including \$1,280,000 of attorney fees which were
4 reported on Form 1099 to appellant's attorney with the remaining \$1,720,000 reported on appellant's
5 Form W-2 for 2004. A second payment of \$2,300,000 was paid in January of 2005 and reported on
6 appellant's Form W-2 for 2005. DPGM withheld California taxes on the \$4,020,000 payments issued to
7 appellant on his Form W-2s for 2004 and 2005. (Resp. Op. Br., pp. 5-6.)

8 Appellants filed a Form 540NR part-year resident California return for 2004 and a Form
9 540NR non-resident California return for 2005. On the 2004 return, appellant reported federal adjusted
10 gross income of \$1,827,436 but only \$74,247 in wages and \$76,901 in California adjusted income, with
11 a resulting tax liability of \$6,239. For 2005, appellant filed a non-resident return reporting \$2,483,141
12 in federal adjusted gross income with no California-source income. Appellant received a refund of the
13 entire amount for the 2004 and 2005 tax years. (Resp. Op. Br., p. 6).

14 Respondent subsequently audited the 2004 and 2005 returns and determined that
15 appellant's payments under the settlement agreement were properly California-source income as the
16 payments related to appellant's employment with DPGM. Respondent issued Notices of Proposed
17 Assessment (NPAs) on December 7, 2009, that reversed the refunded amounts for 2004 and 2005 and
18 imposed interest. (Resp. Op. Br., Exhibit K.) After a timely protest, respondent issued Notices of
19 Action (NOAs) related to 2004 and 2005 that affirmed the assessments on September 16, 2011.
20 Appellant timely appealed the assessments of tax and interest.

21 Contentions

22 Appellants' Appeal Letter and Opening Brief

23 Appellant asserts that he was a Washington resident beginning in August 2004 and
24 contends that respondent is assessing him for income earned while a resident of Washington, working
25 for a company based in Virginia.¹⁰ (AL, p. 6.) Appellant argues that pursuant to Revenue and Taxation
26 Code (R&TC) 17041, subdivisions (b) and (d), non-residents are taxed only on taxable income derived
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28 ¹⁰ Appellant cites *Appeal of Janice Rule*, 76-SBE-099, decided by the Board on October 6, 1976, in support of his contentions.

1 from sources in California, and that he is being assessed for monies that were paid to respondent in
2 error.

3 Appellant references the granting of his refunds, and asserts that the FTB already has
4 ruled that he was entitled to the money with interest as it was determined that there was no
5 California-source income. (AL, p. 6.) Appellant contends the Settlement Agreement payments were not
6 paid for services performed, or to refrain from providing services in California in the future. (App. Op.
7 Br., p. 9.) Appellant asserts that respondent does not dispute appellant's permanent residency when the
8 payments were made and to the extent any portion of the payments are attributable to California, the
9 amount is minimal. (*Id.*) Appellant asserts that the only portion of the payments attributable to work
10 that he performed was the \$7,500 in back wages specifically noted in the Settlement Agreement.
11 Appellant asserts that this related to work performed in Washington during the month of October 2004
12 and that California is taxing those wages as well. (AL, pp. 4-5.)

13 Appellant asserts that respondent already had an opportunity to review the facts when it
14 originally refunded the amounts in dispute and that respondent did not provide him with requested
15 information about the review and refund process aside from the redacted document with the
16 determination that there was no California-source income. (AL, pp. 5-6, 8.) Appellant contends that
17 California clients included in the non-solicitation provision of the Settlement Agreement were a very
18 small part of the overall agreement. Appellant asserts that the California clients only accounted for
19 .82 percent of his total sales and that the source of his future competition would have been from
20 Washington, not California.¹¹ (AL, p. 3, App. Op. Br., p. 8.) He argues that his non-Amazon major
21 clients were excluded from the Settlement Agreement's non-solicitation clause and the non-Amazon
22 clients covered by the non-compete were only 1.34 percent of appellants' total sales. (App. Op. Br.,
23 p. 8, Exhibits 1, Exhibits F-1, Exhibit T.)

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26 ¹¹ Appellant alleges that non-Amazon clients covered by the non-solicitation provisions account for only 1.34 percent of his
27 total sales. (App. Op. Br., p.8, Exhibit T.) A footnote on page 8 of his brief states that non-Amazon clients represent 1.47
28 percent (rather than 1.34 percent) of sales, but this small discrepancy or typographical error does not appear material. In his
exhibits, appellant contends that sales numbers from March of 2003 defined his client base as follows: Amazon represented
90.95 percent of his sales base, non-Amazon clients included in the settlement agreement represented an additional 1.34
percent of his sales base, and the five major clients excluded from the non-solicitation provisions accounted for 7.71 percent
of his sales base. Appellant indicates that none of the major clients that were excluded from the non-solicitation provisions
were California clients. (App. Op. Br., p.8, Exhibit 1, Exhibit F-1, Exhibit T.)

1 Appellant references R&TC section 17951 et seq. to explain that nonresidents are taxed
2 only on their California-source income. (App. Op. Br., p. 10.) Appellant asserts that the settlement
3 payment does not meet the enumerated income classifications mandating sourcing to California. (App.
4 Op. Br., p. 11.) Referencing California Code of Regulations, title 18, (Regulation) section
5 17951-6(a)(4), appellant contends that the agreement would only be sourced to California if he was
6 agreeing not to compete in California. (App. Op. Br., p. 11.) Appellant asserts that *Appeal of James B.*
7 *and Linda Pesiri*, 89-SBE-027, decided by the Board on September 26, 1989 and *Milhous v. Franchise*
8 *Tax Board* (2005) 131 Cal.App.4th 1260 control here, requiring the proceeds be sourced outside of
9 California because the covenant not to compete had no value in California. (App. Op. Br., p.12.)

10 Appellant argues that, as was specifically indicated in the terms of the agreement, a large
11 portion of the settlement was for a covenant not to compete against DPGM for the Amazon account as
12 appellant's connections and knowledge of Amazon's business would have been valuable to the
13 company's competitors. (App. Op. Br., p. 13.) Appellant asserts that if the non-compete had not been
14 signed in November 2004, DPGM would have had legitimate concerns that appellant may have posed a
15 threat to the 2-year contract renegotiations with Amazon in the spring of 2005. (App. Op. Br., p. 13.)

16 Appellant contends that the settlement constitutes a payment for releasing his claims is an
17 intangible right that followed appellant to Washington under the doctrine of "*mobilia sequuntur*
18 *personam* – movables follow their owner" unless the property has established a business situs in the
19 state. (App. Op. Br., p. 15.) Citing *Holly Sugar Corp. v. McColgan*, (1941) 18 Cal.2d 218, 233,
20 appellant asserts that in the context of an intangible asset, a nonresident owner can only be taxed if the
21 intangible asset is an integral part of a continuous California business. (App. Op. Br., p.16.) Appellant
22 asserts that his claims pursuant to the litigation "resemble most closely an intangible personal property
23 right."¹² (App. Op. Br., p. 16.) Appellant asserts that when he received the payments to release those
24 personal rights, the rights were not attached to California "merely because the chosen venue to vindicate
25 those rights happens to be in California." (App. Op. Br., p. 17.) Alternatively, appellant asserts that the
26 rights were inchoate personal rights and had not developed into a property right that would have fit
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28 ¹² Appellant cites *Everts v. Will S. Fawcett Co.* (1937) 24 Cal.App.2d 213, 215, *Vick v. DaCorsi* (2003)110 Cal.App.4th 206, 213.

1 within one of the five categories of taxable income provided for in R&TC section 17951 and Regulation
2 section 17951. (App. Op. Br., p. 17.)

3 Appellant also argues that any portion of the amount related to personal services is
4 minimal. (App. Op. Br., p. 17.) Appellant asserts that “[i]t makes no logical sense that payment for
5 *past*, previously earned wages could be 17 times that of his largest annual salary.” (App. Op. Br., p. 18.)
6 Appellant asserts that at most, only \$196,765 of the payment related to the commissions and kickers
7 calculated by him as owed to him from the 2001 through 2002 work he performed on the Amazon
8 account. (App. Op. Br., p. 18.)

9 Respondent’s Opening Brief

10 Respondent does not challenge that appellant was a non-resident of California at the time
11 the settlement was entered into, and the payments made. Instead, respondent asserts that appellant
12 “entered into a settlement agreement releasing claims against his former employer and promising to
13 refrain from soliciting employees or customers from his employer based on a dispute that arose with
14 respect to appellant’s employment agreement effective June 1, 2000.” (Resp. Op. Brief, p. 1.) Citing
15 R&TC section 17041, respondent explains that California taxable income of a California nonresident
16 includes the income derived from California sources. Pursuant to R&TC section 17951 and Regulation
17 17951-2, income from sources within this State includes personal services compensation performed
18 within this State. (Resp. Op. Br. p. 6.)

19 Respondent asserts that “[i]t is well settled that the character of settlement awards is
20 determined by the nature of the underlying claim.” (Resp. Op. Br., p. 1.) Respondent argues that
21 appellant performed nearly all of his services related to the June 1, 2000 employment contract in
22 California. Respondent contends that the “origin of claim” doctrine is controlling in this instance.
23 Respondent asserts that although the test was originally used to determine the character of litigation
24 costs, the standard has been further expanded to determine the excludability of income from taxable
25 income. Under the doctrine, the character of a settlement payment is determined by the nature of the

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1 litigation.¹³ (Resp. Op. Br., p.7.) Respondent references the Ninth Circuit decision in *Keller Street*
2 *Development v. Commissioner* for the principle that the “claim to be studied is the claim that gave rise to
3 the transaction that created the tax problem.” (Resp. Op. Br., p. 7) (*Keller Street Dev. Co. v. Comm’r*,
4 *supra.*) With regard to appellant’s payments, respondent asserts that the income is not characterized as
5 income from an intangible asset if the claims originated from appellant’s employment.¹⁴ (Resp. Op. Br.,
6 p. 7.) Respondent concludes that the agreement is a dispute over wages and the income is therefore
7 governed by Regulation section 17951-5 as personal services income. (Resp. Op. Br., p. 9.) As
8 appellant lived and worked in California when he originally filed suit regarding his employment
9 relationship, respondent asserts that the payments related to the claims should be sourced to California
10 where those services were performed. (Resp. Op. Br., p. 9.)

11 Respondent analyzes the causes of action in appellant’s underlying lawsuit and contends
12 that the litigation was at its core, a dispute over wages. (Resp. Op. Br., pp. 8-9.) Respondent contends
13 that the Settlement Agreement is not properly analyzed as a covenant not to compete agreement but as a
14 settlement agreement “in connection with an employment contract rather than in connection with the
15 sale of a business” and subject to different sourcing rules. (Resp. Op. Br., p. 10.) Respondent contends
16 that the payments were properly reported on Forms W-2, and therefore pursuant to the Board’s prior
17 decision in the *Appeal of Aldean and Clara Washburn*, 82-SBE-140, decided by the Board on June 29,
18 1982, are properly taxed as ordinary income and not real or personal property. (Resp. Op. Br., p. 11.)

19 Respondent concludes that although appellant moved out of California prior to the
20 settlement, appellant performed nearly all of his work in California, including the work with his most
21 significant client, Amazon. Respondent emphasizes the significance of the fact that the work related to
22 the Amazon account ceased in April of 2003, while he was still a resident of California and working in
23 the state and cites *Appeal of Ronald P. and Gertrude B. Foltz*, 85-SBE-022, decided by the Board on
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25 ¹³ Respondent cites *United States v. Gilmore* (1963) 372 U.S. 39, *Gidwitz Family Trust v. Comm’r* (1974) 61 T.C. 664 citing
26 *Raytheon Production Corp. v. Comm’r* (1st Cir. 1944) 144 F.2d 110, 114 and *Keller Street Dev. Co v. Comm’r.*(9th Cir.
1982) 688 F.2d 675.

27 ¹⁴ Respondent also notes that it incorrectly treated appellant’s payment for legal services under the agreement. Respondent
28 indicates that pursuant to *United States v. Gilmore, supra*, the payment should have been characterized and sourced to
California based on the nature of the underlying claims.

1 April 9, 1985. (Resp. Op. Br., p. 9.)

2 Respondent first asserts that the non-solicitation provisions included in the Settlement
3 Agreement would not properly be classified and analyzed as a non-compete agreement. Respondent
4 provides the definition of a covenant not to compete agreement as “generally part of a contract of
5 employment or a contract to sell a business, in which the covenantor agrees for a specific period of time
6 and within a particular area to refrain from competition with a covenantee.” (Resp. Op. Br., p. 10.)
7 Respondent contrasts that with a non-solicitation agreement which protects the assets of a party and
8 characterizes the prohibition from recruiting employees or independent contractors for DPGM for one
9 year, or from soliciting customers with limited exceptions for six months as non-solicitation provisions
10 (Resp. Op. Br., p. 10.) Respondent contends that the source of compensation received for a covenant
11 not to compete is where the promisor gave up the right to act. Here, respondent asserts, an additional
12 indicator that the payment is not properly characterized as a payment for a non-compete agreement is
13 that no geographic boundaries were provided, as the source of compensation would be the geographic
14 place where the promisor refrained from acting. (Resp. Op. Br., p.11.)

15 Alternatively, respondent contends that if the provisions were properly classified as
16 non-competition provisions, the income still would have been sourced to California. Respondent
17 contends that appellant’s reliance on Regulation section 17951-6 and *Milhous v. Franchise Tax Board*,
18 *supra*, that address the sourcing of non-competition agreements in the connection with the sale of a
19 business is misplaced.¹⁵ Respondent contends that special sourcing rules apply to the intangible
20 property rights associated with covenants not to compete that are associated with the sale of a business
21 and they do not apply to covenants not to compete associated with employment agreements. (Resp. Op.
22 Br., pp. 11-12.) Instead, respondent asserts the income should be sourced to California as income from
23 the performance of personal services. (*Id.*)

24 Citing *Appeal of Aldean and Clara Washburn, supra*, respondent asserts that the Board
25 has determined that a covenant not to compete or compensation received from refraining from labor is
26 characterized and taxed as ordinary income rather than income associated with real or intangible
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28 ¹⁵ As discussed in more detail below, Regulation section 17951-6 provides the rules related to the sourcing of covenant not to compete agreements that arise in connection with the sale of a business.

1 property rights. Respondent contends that the Settlement Agreement payments were not allocated
2 specifically between the agreement not to solicit provisions and the provisions governing the settlement
3 of his employment disputes, and should be sourced completely to California based on the underlying
4 claims. (Resp. Op. Br., p. 11.)

5 Appellant's Reply Brief

6 Appellants reiterate that the settlement was "primarily to refrain from soliciting business
7 in Washington, not California." (App. Rep. Br., p. 2.) Appellant asserts that respondent is ignoring the
8 significance of the expressed intent in the settlement where the parties agree that the non-solicitation
9 provisions are an essential and fundamental part of the agreement. (App. Rep. Br., p. 6.) Appellant
10 contends that the term solicit in the agreement is broadly defined such that it is "equivalent to a covenant
11 not to compete and the provision is not materially distinguishable for purposes of applicable law."
12 (App. Rep. Brief, p. 4.) In addition, appellants assert that the settlement payment was not related to
13 personal services performed by appellant or for his intangible right to do business in California. (App.
14 Rep. Brief, p. 4.) Appellants assert that "[t]he settlement payment was for his promise to refrain from
15 soliciting customers from his employer located outside of California, primarily Amazon" and that
16 refraining from soliciting appellant's former California clients would have little or no value. (App. Rep.
17 Brief, p. 4.)

18 Appellant asserts that the FTB's opening brief misstates the appropriate issue to be
19 considered and incorrectly applies the "origin of the claim" doctrine as that doctrine originated in the
20 context of determining the proper character of income (i.e., ordinary, capital or tax exempt). Appellants
21 assert that as the character of the income is not at issue, the doctrine is being misapplied by respondent.
22 (App. Rep. Brief, p. 1.) Appellant contends that the determination of the character of an expense, as in
23 ordinary income or capital gain, is distinct from the question of whether an item should be sourced to a
24 state. (App. Rep. Brief., p. 5.) However, in the absence of express language, appellant asserts that the
25 question to be asked is what the damages were awarded for.¹⁶ (App. Rep. Brief, p. 7.)

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28 ¹⁶ Although denying the applicability of the origin of the claim doctrine as articulated by respondent, appellant indicates that consistent with the *Keller Street Dev. Co. v. Comm'r, supra*, and *Gidwitz Family Trust v. Comm'r, supra*, *Fono v. Comm'r* 79 T.C. 680 (1982) affd. 749 F.2d 37 (9th Cir. 1984), and *Knuckles v. Comm'r*, 349 F.2d 610, 613 (10th Cir. 1965), the inquiry of the nature of the claim goes to the settlement agreement and the intent of the payor.

1 With regard to past due wages, appellant asserts that the \$7,500 specifically identified in
2 the agreement was paid separate and apart from the settlement agreement. Appellant asserts that Section
3 6(iii) of the Settlement Agreement provides that the payment was in addition to any amount already paid
4 to him as wage compensation. (App. Rep. Brief, p. 7.) Appellant contends that he was paid (1) to
5 ensure that he not solicit Amazon’s business and (2) for the waiver of his right to continue his suit
6 regarding DPGM’s conduct. Appellant asserts that under California law, those rights that generated the
7 payment had a situs in Washington, not California.

8 Appellant contends that the provisions of the settlement agreement meet the requirements
9 of California law to qualify as a covenant not to compete.¹⁷ Appellant references the definition provided
10 in Regulation section 17951-6 which also includes covenants not to solicit employees or disclose
11 proprietary information. (App. Rep. Br., p. 8.) Appellant also contends that respondent is incorrect
12 regarding the ability to rely, in this instance, on authority governing covenants not to compete associated
13 with sales of businesses. (App. Rep. Br., pp. 9-10.) Appellant asserts that “the situs of the intangible
14 property or the performance of the service is the location where such competition would have occurred
15 absent the covenant” and it is there that the income should be sourced, regardless of whether the
16 covenant is entered into pursuant to a sale of a business or related to a settlement agreement. (App. Rep.
17 Br., p. 11.)

18 Appellant contends that when an agreement is silent as to the allocation of a payment
19 between claims, taxing authorities can and should make a reasonable allocation of the payment when it
20 is based on credible evidence that the payment is compensation for a covenant not to compete and the
21 payment is economically reasonable. (App. Rep. Br., pp. 11-12.) Appellant contends that a significant
22 portion of the payment should be allocated to the prohibition on appellant soliciting Amazon. With
23 regard to the other provisions, appellant also reiterates its contention that under the doctrine of *mobilia*
24 *sequuntur persona*, the intangible rights associated with those claims followed appellant to Washington.
25 (App. Rep. Br., p. 12.)

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28 ¹⁷ Appellant cites *Reeves v. Hanlon* (2004) 33 Cal.4th 1140, 1149 and *Dowell v. Biosense Webster, Inc.* (2009) 179 Cal.App.
4th 564, 577.

1 Applicable Law

2 Respondent’s determination of an assessment is presumed correct and appellant has the
3 burden of proving it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael E.*
4 *Myers*, 2001-SBE-001, May 31, 2001.)

5 As provided in R&TC section 17041, subdivision (b), California imposes a tax upon the
6 California-source income of part-year residents and nonresidents for periods when they are nonresidents
7 and upon their income from all sources for periods when they are California residents. For purposes of
8 computing California taxable income, R&TC section 17951, and Regulation section 17951-1,
9 subdivision (a), provide that the gross income of nonresidents includes only their gross income from
10 sources within California.

11 What constitutes a reasonable apportionment method so as to properly limit a taxpayer’s
12 gross income to that earned “from sources within this State” pursuant to R&TC section 17951 must be
13 based upon the facts and circumstances of each case. (*Appeal of James B. and Linda Pesiri*,
14 89-SBE-027, Sept. 26, 1989.) In that appeal, nonresident taxpayers sold their California business and
15 entered into a personal covenant not to compete as part of the transaction. Taxpayers argued that the
16 covenant was an intangible and not taxable by California since it did not acquire a tax situs in California.
17 The Board rejected this argument, holding that after limiting the geographic area of the covenant to the
18 place where the business was located, and utilizing the California sales numbers of the business, an
19 allocation of 25 percent of the income related to the covenant not to compete could be sourced to
20 California.

21 In the *Appeal of Aldean and Clara Washburn, supra*, the Board determined that income
22 from covenants not to compete is sourced to the place where the taxpayer promised not to compete (in
23 that appeal, a location in California) in order to determine the source of the income.

24 Regulation section 17951-2 provides that income from sources within California includes
25 compensation for personal services performed in California. (See *Appeal of Robert C. and Marian*
26 *Thomas*, 55-SBE-006, Apr. 20, 1955.) The critical factor that determines the source of income from
27 personal services is not the residence of the taxpayer, the place where the contract for services was
28 executed, or the place of payment, but rather the place where the services are performed. (*Appeal of*

1 *Sam and Betty Spiegel*, 86-SBE-121, June 10, 1986.)

2 R&TC section 17952 provides that income from intangibles to a nonresident is not
3 California source income, unless the intangible has acquired a business situs in this state. If intangible
4 personal property of a nonresident has acquired a business situs in California, then the entire income
5 from the property, including gains from the sale of the property, regardless of where the sale is
6 consummated, is income from sources within California and is taxable to the nonresident. (Cal. Code
7 Regs., tit. 18, § 17952, subd. (c).)

8 Regulation section 17951-6 provides specific guidance on how to assign income to
9 California for a covenant not to compete. The regulation is limited to situations where a covenant is
10 executed in connection with the sale of business. The regulation provides that the first step is to identify
11 the legally enforceable area where the promisor has forfeited the right to act. Income is then assigned to
12 the identified legally enforceable area using the property, payroll and sales apportionment factors of the
13 business that was sold. (Regs., tit. 18, § 17951-6, subd. (a)(1) and subd. (a)(2).)

14 The California Court of Appeal's decision in *Milhous, supra*, involved nonresident
15 taxpayers who never conducted businesses in California, but rather gave up the right to conduct business
16 in California through a covenant not to compete associated with the sale of a business. The court held
17 that California could not tax the value of the covenant because no part of the covenant payments arose
18 from activities in California or from capital which is located in California. (*Milhous, supra*, at p. 1269.)

19 Courts often look to the origin or nature of the claim in the underlying suit to determine
20 the tax consequences of an award. (See *U.S. v. Gilmore, supra*, 372 U.S. 39; *Woodward v. Comm'r*,
21 (1970) 397 U.S. 572, 578; *Keller St. Dev. Co. v. Comm'r, supra*, 688 F.2d 675, 678 - 680.) The doctrine
22 originated in the decision in *U.S. v. Gilmore* which involved the deductibility of legal fees incurred
23 related to a divorce. The *Gilmore* court determined that the husband's legal fees could not be deducted,
24 even though his goal when incurring those expenses was to protect his corporations from community
25 property claims of his wife. The court found the underlying claims stemmed entirely from the marital
26 relationship rather than the income-producing activity, and the husband was not allowed to classify the
27 legal expenses as a business expense. (*U.S. v. Gilmore, supra*.)

28 The determination of the taxable consequences of a settlement payment is a factual

1 inquiry of what the settlement settled. (*Stocks v. Comm’r* (1992) 98 T.C. 1, 10.) To determine the tax
2 consequences of an award or settlement agreement, courts often analyze the payment from the
3 perspective of the payor. (See *Fono v. Comm’r, supra*, 79 T.C. 680 (affd. 749 F.2d 37 (9th Cir. 1984),
4 and *Knuckles v. Comm’r, supra*, 349 F.2d 610.) If the settlement agreement lacks express language
5 stating what the settlement amount was paid to settle, then the most important factor in determining the
6 tax consequences of the agreement is to examine the intent of the payor regarding the purpose in making
7 the payment. (*Stocks v. Comm’r, supra.*)

8 STAFF COMMENTS

9 It appears to staff that the critical issue is whether the payments arose from services
10 performed in California, as respondent contends, or whether the payments were attributable to the
11 nonsolicitation agreement, as appellant contends. In making this determination, the Board should
12 consider all the relevant facts and circumstances.

13 Appellant has the burden of establishing that the waiver of all claims and appellant’s
14 promise not to act under the provisions of the nonsolicitation provisions are not properly treated for
15 sourcing purposes as arising from personal services rendered in California.

16 It appears to staff that the language in the Settlement Agreement stating that the parties
17 agree as an “essential and fundamentally material part of the Agreement that [appellant] will be bound
18 by the nonsolicitation provisions” may have been intended to ensure that the nonsolicitation provision
19 was enforced and not separately challenged or severed from the agreement. The parties should be
20 prepared to discuss whether the language suggests that the primary purpose of the settlement payments
21 was to obtain the nonsolicitation agreement, or, alternatively, whether the language suggests that the
22 nonsolicitation provision was an inextricable part of a settlement that primarily related to compensation
23 for services performed in California.

24 Staff notes that the Settlement Agreement required a waiver of all claims related to
25 unpaid wages, the breach of written contract, breach of implied covenant of good faith and fair dealing,
26 negligent misrepresentation, conversion, fraud, accounting, and constructive trust, retaliation, and
27 negligence per se as enumerated in the original and amended causes of action in the underlying lawsuit.
28 The Settlement Agreement payments were also issued in return for appellant’s promise not to act under

1 the enumerated non-solicitation provisions, to waive any future employment rights with DPGM, and in
2 return for appellant's waiver of any additional claims provided in the Supplemental Release Agreement
3 giving up all claims under the federal Age Discrimination in Employment Act of 1967, as amended.

4 Respondent should be prepared to address appellant's contention that the bulk of the
5 value of the settlement related to the nonsolicitation provision and specifically related to his agreement
6 not to solicit Amazon. If the Board determines that an allocation is appropriate between the discrete
7 claims settled under the Settlement Agreement and appellant's agreement to the non-solicitation
8 provisions, appellant should be prepared to specifically identify evidence demonstrating how much
9 value should be attributed to the nonsolicitation agreement.

10 Respondent will also want to address appellant's assertions that the \$7,500 payment
11 specifically identified in the Settlement Agreement related to commissions appellant received for work
12 performed in the month of October 2004 (after he moved), and whether the assessment subjected this
13 portion of the payment to tax.

14 Pursuant to Regulation section 5523.6, if either party has any additional evidence to
15 present, it should provide the evidence to the Board Proceedings Division at least 14 days prior to the
16 oral hearing. Evidence exhibits should be sent to: Khaliq Abd' Allah, Associate Governmental
17 Program Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC: 80,
18 Sacramento, California, 94279-0080.

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