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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 **EDDIE C. DAVIS AND CYNTHIA L. DAVIS¹**) Case No. 538607

14 Year Proposed
15 2005 Assessment
16 \$183,534

16 Representing the Parties:

18 For Appellants: Janathan L. Allen, Attorney
19 For Franchise Tax Board: Maria Brosterhous, Tax Counsel

21 **QUESTION:** Whether respondent properly determined appellants' 2005 California-source income
22 resulting from the exercise of nonqualified stock options (NQSOs).

23 HEARING SUMMARY

24 Background

25 Appellants contest respondent Franchise Tax Board's (FTB) proposed assessment of tax
26 in the amount of \$183,534 for the 2005 tax year. This assessment is based on NQSOs received by
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28 ¹ Appellants reside in San Diego County.

1 appellant-wife in connection with her employment at 7-Eleven, Inc. (7-Eleven). Appellant-wife began
2 working for the company on July 7, 1978, and was employed by 7-Eleven during the 2005 tax year.
3 Appellants filed returns reporting California residency for the following earlier periods:

- 4 • Mid-1978 through part of 1987;
- 5 • Part of 1992 through part of 1993; and
- 6 • 2000 through 2004 tax years.

7 In 2005, appellant-wife was promoted to a new position at 7-Eleven and she began
8 performing services in Texas beginning February 7, 2005. Appellants reported that they became
9 nonresidents of California on July 11, 2005. (Resp. Op. Br., Ex. A.) Appellants filed as part-year
10 residents of California for 2005. Appellant-wife's 2005 Form W-2 from 7-Eleven indicated total wages
11 of \$3,436,791. Of this amount, \$389,159 was reported as California wages. The W-2 also reported
12 "Code V" income, income from the exercise of NQSOs, of \$937,866. (Resp. Op. Br., Ex. B.)

13 Between 1997 and 2005,² appellant-wife received the following ten grants of NQSOs.
14 (Resp. Op. Br., Ex. C.):

<i>Group No.</i>	<i>Grant Date</i>	<i>Shares</i>	<i>California resident at time of grant?</i>
1	11/12/1997	9,000	No
2	10/14/1998	11,600	No
3	10/08/1999	10,000	No
4	5/23/2000	23,920	Yes
5	5/14/2001	9,500	Yes
6	4/24/2002	20,000	Yes
7	3/7/2003	15,000	Yes
8	1/21/2004	14,720	Yes
9	1/17/2005	7,540	Yes
10 ³	5/2/2005	4,060	No

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23 Seven groups of options were awarded at the time appellant-wife was a California resident. The NQSOs
24 were awarded pursuant to the 1995 Stock Incentive Plan which specified the options were subject to
25 either a three-year or five-year vesting schedule. The vesting of the options was conditioned upon
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27 ² NQSOs granted prior to January 1, 2001, were subject to a one-for-five reverse split as of that date.

28 ³ The stock options in Group 10 are not at issue because this group was granted, vested, and exercised while appellant-wife was performing services outside California. (Resp. Op. Br., p. 5.)

1 appellant-wife's continued employment at 7-Eleven, subject to specific exceptions such as retirement,
2 disability, or death. Any shares that remained unvested as a result of a termination that was not
3 enumerated in the agreement were subject to forfeiture. (Resp. Op. Br., Ex. D.)

4 During the 2005 tax year, appellant-wife exercised four of the ten groups of NQSOs: the
5 first group granted on November 12, 1997 (Group 1); the second group granted on October 14, 1998
6 (Group 2); the third group granted on October 8, 1999 (Group 3); and a portion of the fourth group
7 granted on May 23, 2000 (Group 4). On May 20, 2005, appellant-wife exercised 15,000 options of
8 Group 4 which resulted in a taxable gain of \$161,250. (Resp. Op. Br., Ex. E.) On September 15, 2005,
9 appellant-wife exercised all of the options from Group 1, Group 2, and Group 3. The total taxable gain
10 from the exercise of these stock options (from Groups 1, 2, 3, and 4) was \$776,616. (Resp. Op. Br.,
11 Ex. F.)

12 In addition, pursuant to a private buyout of 7-Eleven, a provision of the Stock Incentive
13 Plan was triggered which caused the remaining six groups of 79,740 options (and the balance of the
14 options from Group 4) to be exercised on November 14, 2005. (Resp. Op. Br., Ex. G.) The exercise of
15 these remaining options was included in appellant-wife's 2005 wage income as an equity payment of
16 \$1,921,796.40.

17 In summary, appellant-wife received the following payments from the exercise of her
18 stock options in 2005:

<i>Group No.</i>	<i>Grant Date</i>	<i>Shares</i>	<i>Exercise Date</i>	<i>Exercise Price</i>	<i>Sales Price</i>	<i>Gain Per Share</i>	<i>Payment</i>
1	11/12/1997	9,000	9/15/2005	n/a	35.69	n/a	\$776,616.00
2	10/14/1998	11,600	9/15/2005				
3	10/8/1999	10,000	9/15/2005				
4a	5/23/2000	15,000	5/20/2005	19.00	29.75	10.75	161,250.00
4b	5/23/2000	8,920	11/14/2005	19.00	37.50	18.50	165,020.00
5	5/14/2001	9,500	11/14/2005	10.92	37.50	26.58	252,510.00
6	4/24/2002	20,000	11/14/2005	9.12	37.50	28.38	567,600.00
7	3/7/2003	15,000	11/14/2005	6.88	37.50	30.62	459,300.00
8	1/21/2004	14,720	11/14/2005	16.21	37.50	21.29	313,388.80
9	1/17/2005	7,540	11/14/2005	22.79	37.50	14.71	110,913.40
10	5/2/2005	4,060	11/14/2005	24.43	37.50	13.07	53,064.20
	Total	125,340					\$2,859,662.40

1 For the income recognized upon the exercise of NQSOs during appellants' 2005 tax year,
 2 respondent treated the NQSO income as compensation income and treated a portion of such income as
 3 California-source income. Respondent calculated the California-source income by multiplying
 4 appellant-wife's taxable gain from the exercise of the NQSOs by a ratio of appellant-wife's California
 5 days from the grant date to the exercise date of the NQSOs over the total days during the same time
 6 period.⁴ Respondent determined that appellants had total California-source income of \$1,866,473
 7 resulting from the exercise of the NQSOs in 2005 based on the proration as follows (Resp. Op. Br., pp.
 8 4-5):⁵

<i>Shares</i>	<i>Date Granted</i>	<i>Exercise Date</i>	<i>California Days</i>	<i>Total Days</i>	<i>California %</i>
15,000	5/23/2000	5/20/2005	1,130	1200	94
9,000	11/12/1997	9/15/2005	1,126	1,863	60
11,600	10/14/1998	9/15/2005	1,126	1,641	69
10,000	10/8/1999	9/15/2005	1,126	1,405	80
8,920	5/23/2000	11/14/2005	1,130	1,315	86
9,500	5/14/2001	11/14/2005	1,135	1,320	86
20,000	4/24/2002	11/14/2005	670	855	78
15,000	3/7/2003	11/14/2005	460	645	71
14,720	1/21/2004	11/14/2005	250	435	57
4,060	1/17/2005	11/14/2005	15	200	8

17 On May 22, 2009, respondent issued a Notice of Proposed Assessment for the 2005 tax year that
 18 increased appellants' California taxable income to \$2,251,611, and proposed an assessment of California
 19 tax of \$183,534. (Resp. Op. Br., Ex. H.)

20 Appellants protested respondent's determination. Respondent's determination was
 21 affirmed by the Notice of Action issued on June 28, 2010. (Resp. Op. Br., Ex. I.) Appellant then filed
 22 this timely appeal.

Contentions

Appellants

25 In their opening brief, appellants contend that the stock options at issue are restricted

27 ⁴ This calculation includes the NQSOs which resulted in the equity payment.

28 ⁵ The options in Group 10 granted on May 2, 2005, were treated as non-California sourced because services were performed by appellant-wife exclusively within Texas from the date of grant to the date of exercise.

1 stock options because the exercise of the options granted to appellant-wife was conditioned upon her
2 continued employment. Appellants contend, pursuant to Internal Revenue Code (IRC) section 83, that
3 the value of restricted stock transferred to an employee in connection with the performance of services is
4 taxable once the interest in the property becomes transferrable or is no longer subject to a substantial
5 risk of forfeiture. Citing Treasury Regulation section 1.83-7(a), appellants contend that the amount
6 includable in gross income is the difference between the option price and the fair market value of the
7 option when transferable or not subject to a substantial risk of forfeiture. As such, appellants disagree
8 with the FTB's allocation method using the California working days ratio to the amount realized upon
9 exercise of the option rather than the date when the restricted option vested. (App. Op. Br., p. 1-2.)

10 Appellants note that California Code of Regulations, title 18, section (Regulation) 17951-
11 5(b) provides that if a taxpayer performed services for a corporation both within and without California,
12 the FTB is required to allocate to California that portion of total compensation reasonably attributed to
13 services performed in California. Appellants further note that in the *Appeal of Charles W. and Mary D.*
14 *Perelle*, 58-SBE-057, decided on December 17, 1958,⁶ the Board held that, if a taxpayer exercises his
15 NQSOs while a nonresident of California, the character of the stock option income recognized is
16 compensation for services rendered. Appellants contend that as the present matter involves restricted
17 stock options, and not NQSOs, there is no authority supporting the use of the exercise date, rather than
18 the vest date, in determining the taxable event. Appellants contend that when a restricted stock option
19 vests, because it is no longer subject to a substantial risk of forfeiture, such option can no longer
20 logically be attributed to services performed subsequent to the vesting. Accordingly, appellants initially
21 assert that the allocation of the compensation should be based on the number of California days from
22 grant date to vest date. Appellants also indicate that they made a prepayment of the proposed
23 assessment in the amount of \$72,859 which they contend represents the true amount of income tax owed
24 to the FTB in 2005 from the stock options granted to appellant-wife. (App. Op. Br., p. 2.)

25 In appellants' reply brief, they continue to contend that respondent's use of the working
26 days ratio does not take into account the terms of the option contract and results in a high proportion of
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28 ⁶ Board of Equalization cases may be found at the Board's website (www.boe.ca.gov).

1 income being allocated to California in this case. Citing the Board's decision in the *Appeal of Melvin A.*
2 *and Adele R. Gustafson*, 88-SBE-027, decided on November 29, 1988, appellants assert that
3 respondent's allocation is arbitrary and produced an unreasonable result. However, appellants currently
4 contend the vest date to exercise date allocation is more reasonable due to the terms of the stock option
5 agreement. Appellants again cite Regulation 17951-5(b) for the contention that the allocation of
6 compensation must be reasonable. Appellants also cite the Board's decision in the *Appeal of James B.*
7 *and Linda Pesiri*, 89-SBE-027, decided on September 26, 1989, to support their contention that the
8 FTB's reasonable allocation must be based on the facts and circumstances of each case. (App. Reply
9 Br., pp. 2-3.)

10 Appellants contend that the Incentive Stock Plan Award Agreements between appellant-
11 wife and 7-Eleven show that she had no taxable interest as of the grant date. Appellants note that the
12 options were subject to cancellation at any time until the vesting date. Appellants further note that
13 appellant-wife was only entitled to income if certain contractual conditions were met, such as continued
14 employment. Appellants assert that the performance of services prior to the vesting date was irrelevant
15 as such services could be performed without appellant-wife receiving any compensation. Appellants
16 assert that it is only by appellant-wife's continued services from the vesting date to the exercise of the
17 options that any income was ever earned by and allocated to appellant-wife. Therefore, appellants
18 contend that the only reasonable allocation ratio would commence on the vesting date and end on the
19 exercise date to attribute the income for personal services performed within California. Accordingly,
20 appellants request that the Board apply the vest date allocation method to the NQSOs exercised in 2005.
21 (App. Reply Br., p. 2-3.)

22 Respondent

23 Respondent contends that gains from the exercise of NQSOs constitute compensation
24 income and, because appellant-wife performed services in California during the grant-to-exercise period
25 for the NQSOs, a portion of the NQSO income is California-source income. Respondent states that the
26 taxation of NQSOs is governed by IRC section 83(a) and that, pursuant to Treasury Regulation section
27 1.83-7(a), a taxpayer recognizes taxable compensation to the extent the fair market value of the stock
28 exceeds the option price when the NQSOs are exercised. Respondent cites the United States Supreme

1 Court decision in *Commissioner v. LoBue* (1956) 351 U.S. 243 (*LoBue*) and the Board’s decision in the
2 *Appeal of Charles W. and Mary D. Perelle, supra*, to support its contention that gain from the exercise
3 of NQSOs is characterized as compensation for personal services performed. Respondent also cites the
4 Board’s decisions in the *Appeal of Robert C. and Marian Thomas, 55-SBE-006*, decided on April 20,
5 1955, the *Appeal of Janice Rule, 76-SBE-099*, decided on October 6, 1976 and the *Appeal of Karl*
6 *Bernhardt, 84-SBE-153*, decided on November 14, 1984, to support its contention that a portion of the
7 compensation from the NQSOs is California-source income because appellant-wife performed services
8 in California for her employer at times during the grant-to-exercise period of the NQSOs. (Resp. Op.
9 Br., p. 5.)

10 Respondent further contends that its allocation of the California-source income resulting
11 from the exercise of the NQSOs is reasonable. Respondent states that Revenue and Taxation Code
12 (R&TC) section 17041 provides that the California taxable income of a California nonresident includes
13 gross income and deductions derived from sources within California. Respondent notes that Regulation
14 17951-5, subsection (b), provides that the California-source income is the portion of total compensation
15 which is reasonably attributable to personal services in California. Citing the Board’s decision in the
16 *Appeal of James B. and Linda Pesiri, supra*, respondent indicates that its reasonable allocation must be
17 based on the facts and circumstances of each case. Respondent notes that it multiplied the compensation
18 by a ratio of appellant-wife’s California days from the grant date to the exercise date over the total days
19 during the same period. Respondent calculated the California days during the grant-to-exercise period,
20 starting with the date of the grant for each group and ending on the date of the exercise. Citing the
21 Board’s decision in the *Appeal of Melvin A. and Adele R. Gustafson, supra*, respondent contends that
22 appellants bear the burden of showing that the application is intrinsically arbitrary or that it produced an
23 unreasonable result. (Resp. Op. Br., p. 6.)

24 With respect to appellants’ presumption that the stock options at issue are restricted stock
25 and not NQSOs, respondent notes that the Incentive Stock Plan Award Agreements provided by
26 appellants explicitly refer to the options as nonqualified stock options. Respondent further notes that the
27 agreements’ title specifically states “Grant of Nonqualified Stock Option (NQSO).” (Resp. Op. Br., Ex.
28 C.) As such, respondent contends that the evidence indicates that the options at issue are NQSOs and

1 appellants provided no evidence to support their assertion that the options are restricted stock.
2 Respondent asserts that the Board's decision in determining whether the stock options at issue in the
3 *Appeal of Charles W. and Mary D. Perelle, supra*, had a California-source is applicable to the issue in
4 the present matter. Respondent contends that because the NQSOs in this matter were awarded as
5 compensation for personal services performed in California, the NQSOs have a California-source and
6 should be allocated accordingly. (Resp. Op. Br., p.7.)

7 With respect to appellants' argument that the duty days allocation should be based upon
8 appellant-wife's California work days from grant-to-vest date, respondent contends there is no legal
9 basis for this argument. Respondent argues that this position is in direct contradiction to the provisions
10 of Treasury Regulation section 1.83-7(a) which provides that the exercise date, not the vest date, is the
11 date of tax recognition for purposes of NQSOs. Respondent contends that appellants are simply taking
12 an inconsistent position because it has the most favorable tax consequences. (Resp. Op. Br., pp. 7-8.)

13 With respect to appellants' assertion that the options ceased to be compensation on the
14 date of vest, respondent notes that appellants provided no authority for this position. Respondent argues
15 that the options continued to be compensation because the options continued to have value to appellant-
16 wife beyond the vest date. Respondent further contends that the options continued to be in return for her
17 services. Respondent notes that appellant-wife continued to perform services for 7-Eleven beyond the
18 vest date in the best interests of herself and 7-Eleven. As such, respondent contends that the options
19 continued to increase in value; pursuant to IRC section 83, appellant-wife received the benefit of this
20 increase on the exercise date, not the vest date. (Resp. Op. Br., p.8.)

21 With respect to appellants' assertion that the income from the NQSOs should be taxed
22 from the vest date to exercise date allocation, respondent disagrees for the following reasons:

- 23 • An allocation based on the vesting date is in direct opposition to IRC section 83. Respondent
24 notes that appellant-wife performed services for 7-Eleven during the entire period from grant
25 date to exercise date, not solely from the vest date to the exercise date. Accordingly, respondent
26 argues that her compensation during this period in which she performed services in California
27 had a California-source. Respondent further asserts that, as IRC section 83 does not recognize
28 vesting as a tax recognition event for NQSOs, vesting should not be taken into consideration in

1 determining appellants' California-source income.

- 2 • Appellants' proposed allocation would not accurately reflect the extent to which appellant-wife
3 performed services in California as is required by Regulation 17951-5(b). Respondent argues
4 appellants' proposed allocation would only account for a portion of the time appellant-wife
5 performed services in California, the portion from the vest date to the exercise date. Respondent
6 asserts that, since the NQSOs were compensation for services performed through the exercise
7 date, appellants' allocation violates Regulation 17951-5(b).
- 8 • Appellants also disregard the purpose behind the granting of stock options, which is to encourage
9 employees to work hard for the company they have a stake in and to give them an incentive to
10 stay there. Respondent notes that the stock agreement provides a 3 to 5 year vesting schedule
11 and argues that this schedule is designed to reward employees who commit to the company for
12 more than 3 to 5 years.
- 13 • Appellants' allocation places undue emphasis on the extent to which the options were subject to
14 a risk of forfeiture. Respondent notes that the agreement indicates the stock options were subject
15 to a risk of forfeiture upon termination. Respondent asserts that this is not an extraordinary
16 arrangement and appellant-wife's risk for forfeiture was easily remedied by maintaining her
17 employment for the 3 to 5 year vesting period. Respondent contends that this is fairly standard
18 practice for companies issuing stock options and a part of the incentive strategy behind the
19 issuance of the NQSOs.

20 (Resp. Reply Br., pp. 1-2.)

21 Applicable Law

22 Burden of Proof

23 The FTB's determination is presumed to be correct, and a taxpayer has the burden of
24 proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael E. Myers*, 2001-SBE-
25 001, May 31, 2001; *Appeal of Robert E. and Argentina Sorenson*, 81-SBE-005, Jan. 6, 1981.)
26 Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Aaron and*
27 *Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) In the *Appeal of Melvin A. and Adele R. Gustafson*,
28 *supra*, the Board held that, in the context of reviewing respondent's method of allocating a taxpayer's

1 income from services, the taxpayer bears the burden of showing that the application is intrinsically
2 arbitrary or that it produces an unreasonable result.

3 California Taxation of Nonresidents

4 R&TC section 17041 provides that California imposes an income tax on the entire
5 taxable income of every nonresident to the extent that the nonresident derives the taxable income from
6 sources within California. R&TC section 17951 provides that for purposes of computing California
7 taxable income, the gross income of nonresidents includes only their gross income from sources within
8 California. Compensation for personal services is sourced to the place where the services are
9 performed. (Cal. Code Regs., tit. 18, § 17951-2; *Appeal of Robert C. and Marian Thomas*, 55-SBE-006,
10 April 20, 1955.) The total compensation for personal services must be apportioned between California
11 and other states and foreign countries in which the individual was employed in such a manner as to
12 allocate to California that portion of the total compensation which is reasonably attributable to personal
13 services performed in California. (Cal. Code Regs., tit. 18, §17951-5(b).) What constitutes a reasonable
14 apportionment method so as to properly limit a taxpayer's gross income to that earned "from sources
15 within this State" pursuant to the dictates of R&TC section 17951 must be based upon the facts and
16 circumstances of each case. (*Appeal of James B. and Linda Pesiri, supra.*)

17 R&TC section 17952 provides that a nonresident's income from stocks, bonds, notes or
18 other intangible personal property is not income from sources within this state unless the property has
19 acquired a business situs in this state.⁷ However, R&TC section 17951 is a more specific statute than
20 17952 and the more specific statute governs over the less specific statute. (*See, e.g., United States v.*
21 *Estate of Romani* (1998) 523 U.S. 517, 532.) R&TC section 17951 provides specific instructions for
22 how a nonresident taxpayer should treat his or her California-source income. As discussed below, stock
23 options are considered compensation for personal services. (Int.Rev. Code, §83; *Commissioner v.*
24 *LoBue, supra.*) Pursuant to Regulation 17951-2, compensation for personal services is sourced to the
25 place where the services are performed and pursuant to Regulation 17951-5, subdivision (b),
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27
28 ⁷ R&TC section 17952 further states that when a nonresident buys or sells such property in this state or places orders with
brokers in this state to buy or sell such property so regularly, systematically, and continuously as to constitute doing business
in this state, then the profit or gain derived from such activity is income from sources within California regardless of the situs
of the property.

1 compensation for services must be allocated based on a reasonable apportionment method.

2 Income Tax Treatment on Gain from the Exercise of Non-Qualified Stock Options

3 R&TC section 17081 incorporates IRC section 83 which provides authority for the
4 treatment of NQSOs. IRC section 83(a) provides that a taxpayer does not recognize gain when NQSOs
5 are granted. Rather, when NQSOs are exercised, a taxpayer recognizes taxable compensation to the
6 extent the fair market value of the stock exceeds the stock's option price. (Treas. Reg. §1.83-7(a).)

7 "Restricted stock" exists when a taxpayer's interest in the property is subject to a
8 "substantial risk of forfeiture" and can't be freed of that risk. (Int.Rev. Code, § 83.) Income from
9 restricted stock is deferred until the interest in the property either is no longer subject to that risk or
10 becomes transferrable free of the risk, whichever occurs earlier. (Int.Rev. Code, § 83.) A substantial
11 risk of forfeiture exists where rights in property that are transferred are conditioned, directly or
12 indirectly, upon the future performance (or refraining from performance) of substantial services by any
13 person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of
14 forfeiture is substantial if such condition is not satisfied. (Int.Rev. Code, § 83(c)(1).) Whether a risk of
15 forfeiture is substantial depends on the facts and circumstances. (Treas. Reg. § 1.83-3(c)(1).)⁸

16 In *Commissioner v. LoBue, supra*, the United States Supreme Court held that, where
17 stock options given by a corporation to any employee were not transferable and the employee's right to
18 buy stock under the stock option plan was contingent upon the individual remaining an employee of the
19 company until the stock options were exercised, the taxable gain to the employee should be measured as
20 of the time the options were exercised and not the time the options were granted. The Court rejected the
21 taxpayer's argument that a stock option transaction should be treated as a mere purchase of a proprietary
22 interest in the corporation to which no taxable gain was realized in the year of the purchase. The Court

23 _____
24 ⁸ The Treasury Regulation § 1.83-3(c)(2) provides the following examples of whether substantial risk of forfeiture exists or
25 not:

26 (1) Where stock is transferred to an underwriter prior to a public offering and the full enjoyment of such stock is expressly or
27 impliedly conditioned upon the successful completion of the underwriting, the stock is subject to a substantial risk of
28 forfeiture.

(2) Where an employee receives property from an employer subject to a requirement that it be returned if the total earnings of
the employer do not increase, such property is subject to a substantial risk of forfeiture.

(3) On the other hand, requirements that the property be returned to the employer if the employee is discharged for cause or
for committing a crime will not be considered to result in a substantial risk of forfeiture.

1 stated that a stock option given to an employee as compensation was not a mere purchase of an interest
2 or an arm's length transaction between strangers, but an arrangement by which an employer transferred
3 valuable property to its employees in recognition of their services; thus, the stock option given should be
4 treated as taxable compensation, and not as the mere acquisition of a property interest.

5 The *LoBue* court went on to acknowledge that, "it is of course possible for the recipient
6 of a stock option to realize an immediate taxable gain" where the option has a readily ascertainable
7 market value and the recipient is free to sell it, but noted that, "this is not such a case [as the options at
8 issue] were nontransferable and *LoBue's* right to buy stock under them was contingent upon his
9 remaining an employee of the company until they were exercised." (*Commissioner v. LoBue, supra*, at
10 249.) Furthermore, the Court noted that:

11 the uniform Treasury practice since 1923 has been to measure the compensation to
12 employees given stock options subject to contingencies of this sort by the difference
13 between the option price and the market value of the shares at the time the option is
14 exercised And in its 1950 Act affording limited tax benefits for restricted stock
15 option plans, Congress adopted the same kind of standard for measurement of gains
16 Under these circumstances, there is no reason for departing from the Treasury practice.
17 The taxable gain to *LoBue* should be measured as of the time the options were exercised
18 and not the time they were granted.

19 (*Commissioner v. LoBue, supra*, at 249.) Thus, under the holding in *LoBue*, the taxable gain to an
20 employee who received a restricted stock option in one year and then sold it at a profit in a subsequent
21 year should be measured as of the time the option was exercised and not the time it was granted.

22 In the *Appeal of Charles W. and Mary D. Perelle, supra*, the taxpayer, who was then a
23 California resident, entered into an employment contract in July 1944 by which he agreed to work
24 exclusively for his employer corporation for a period of five years. In September 1944, he received a
25 five-year option to purchase 10,000 shares of stock at a market price designated by him. In December
26 1945, he ceased to work for the employer. In March or April of 1946, he was hired by a Michigan
27 employer. In July 1946, he moved to Michigan. In September of that year, he sold his stock option
28 back to the corporation for \$250,000. On its books, the corporation treated this sum as compensation.
Relying upon the United States Supreme Court's decision in *LoBue*, the Board held that the gain on the
sale of the option was compensation for services. Because the services were performed in California,
the gain was taxable by California despite the taxpayer's status as Michigan residents at the time they

1 sold their option.

2 Reasonable Apportionment Method

3 What constitutes a reasonable apportionment method so as to properly limit a taxpayer's
4 gross income, to income earned from sources in California, must be based upon the facts and
5 circumstances of each case. (*Appeal of James B. and Linda Pesiri, supra.*)

6 In the *Appeal of Melvin A. and Adele R. Gustafson, supra*, the Board discussed the proper
7 apportionment method for a taxpayer's income from meat packing employment services. The issue
8 there was how much of a California credit was the taxpayer allowed for taxes paid to Nebraska.⁹ The
9 taxpayer argued that he spent a minimal amount of time performing his Nebraska services in California
10 (15-30 minutes by phone from California three times per week, plus two weeks presence in Nebraska).
11 On a strict time-based approach this equaled approximately 51.6 percent Nebraska time (i.e., 80 hours
12 Nebraska time to 75 California hours (90 minutes per week times 50 weeks)). Respondent originally
13 relied solely on the three-week presence in Nebraska and deemed the California personal services
14 rendered constituted 94.23 percent of the taxpayer's services (apparently 49 weeks/52 weeks).
15 Respondent later concluded (declining to use the strictly time-based method) that the taxpayer should be
16 deemed to have worked in California for the Nebraska corporation for the same portion of the total year
17 as the Nebraska corporation's income bore to the taxpayer's total income, contending that the taxpayer
18 was compensated for his availability for consultations, not on a per minute basis. On these facts, the
19 Board stated that "where the respondent has applied a formula for [the] allocation of income, the
20 taxpayer bears the burden of showing that the application is intrinsically arbitrary or that it produced an
21 unreasonable result."

22 In the *Appeal of C. J. and Helen McKee* (68-SBE-023), decided by the Board on May 7,
23 1968, the taxpayer was an Oregon resident who also operated a business in Oregon. During the busy
24 season, when the company generally earned its net profits, the taxpayer worked in Oregon. During the
25 off-season, when the company generally operated at a loss, the taxpayer spent time in California. The
26 taxpayer's salary, however, continued throughout the entire year, including the off-season. The taxpayer
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28 ⁹ It was in the taxpayer's best interest to increase the allocation to Nebraska in order to increase the credit, while it was in respondent's best interest to increase the allocation of work to California to decrease the credit.

1 also received annual bonuses, apparently based upon corporate profits. On his return, the taxpayer
2 sourced one-half of his salary to California, but none of his annual bonus to California. Despite the fact
3 that the taxpayer spent approximately one-half of each year in California, the Board found that none of
4 the bonus could reasonably be sourced to California because the bonus was based upon the corporation's
5 net profits and during the off-season months the corporation generally operated at a loss while the
6 taxpayer was in California. The Board noted that the corporation's net profits were earned during the
7 time when the taxpayer was present in Oregon and actively engaged in managing the business. Thus,
8 the Board determined that the bonus was attributable to sources outside of California.

9 STAFF COMMENTS

10 In general, a "stock option" is an unexercised right to buy stock of a corporation for a
11 fixed price (which may be nominal) at some fixed time in the future – regardless of how much the stock
12 price may have increased during the time period from the date the option was granted. Stock options are
13 often provided to employees as consideration for their services to the corporation. The employee,
14 however, technically does not own the stock option granted to him or her prior to vesting, which
15 typically is tied to a set number of years of continued employment with the corporation. Once stock
16 options vest, such options generally must be exercised within a range of time established by the plan.

17 It appears to the Appeals Division staff that appellants contend the apportionment method
18 used by respondent is unreasonable and arbitrary because it does not take into account certain
19 contractual conditions placed on the stock as discussed in the stock agreement. (App. Reply Br., p. 2.)
20 Appellants assert that the performance of services prior to the vesting date is irrelevant as such services
21 could be performed without appellant-wife receiving any compensation. (*Ibid.*) Therefore, appellants
22 assert that the vesting date to the exercise date is a more accurate apportionment method to determine
23 the amount of income attributable to the stock options. Appellants should be prepared to discuss how
24 the FTB's method is "intrinsically arbitrary or that it produced an unreasonable result." (*Appeal of*
25 *Melvin A. and Adele R. Gustafson, supra.*) Further, if appellants maintain that the stock options at issue
26 are restricted stock, appellants should be prepared to explain why the stock options should be considered
27 as such despite the fact that the Incentive Stock Plan Award Agreements provided by appellants
28 explicitly refer to the options as "nonqualified stock options." (Resp. Op. Br., Ex. C.)

1 Respondent should be prepared to explain how its apportionment method using work
2 days from the grant-to-exercise date is reasonable. Respondent should also be prepared to discuss why
3 appellants' alternative method of using work days from the vest to exercise date violates Regulation
4 17951-5(b). In addition, if appellants maintain that the stock at issue should be characterized as
5 restricted stock options, respondent should be prepared to explain the substantial risk of forfeiture
6 standard in determining whether the stock options at issue should be considered restricted stock and
7 explain why the requirement to continue providing services to an employer does not constitute a
8 substantial risk of forfeiture for purposes of IRC section 83.

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