

1 Anthony S. Epolite
2 Tax Counsel IV
3 Board of Equalization, Appeals Division
4 450 N Street, MIC: 85
5 PO Box 942879
6 Sacramento CA 95814
7 Tel: (916) 323-3134
8 Fax: (916) 324-2618

6 Attorney for the Appeals Division

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

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **RICHARD A. GAETO AND**) Case No. 550369
13 **COLLEEN P. GAETO¹**)

	<u>Year</u>	<u>Proposed Assessments</u>
	2004	\$70,898

17 Representing the Parties:

19 For Appellant: Walter Weiss, Attorney
20 For Franchise Tax Board: Maria Brosterhous, Tax Counsel

22 QUESTIONS: (1) Whether respondent properly determined appellants' California source income
23 resulting from the exercise of nonqualified stock options (NQSOs).
24 (2) Whether respondent properly calculated the rate of taxation, as required by
25 Revenue and Taxation Code (R&TC) section 17041, subdivision (b), and included
26 the appropriate amounts of appellants' income in such calculation.

28 ¹ Appellants reside in Washington State.

1 HEARING SUMMARY

2 Background

3 Appellants resided in Washington State and appellant-husband was an employee of
4 Immunex Corporation (Immunex), a Washington corporation, from January 1994 until July 2002. In
5 July 2002, Immunex was purchased by Amgen Inc. (Amgen), a California corporation.² Amgen sent
6 appellant-husband a letter, offering him employment at Amgen, subject to his relocation to California.
7 Appellant-husband agreed and relocated to California along with appellant-wife (beginning their
8 California residency on August 15, 2002), working for Amgen from August 2002 through May 2004.
9 Appellant-husband terminated his employment with Amgen on May 13, 2004. Appellants returned to
10 Washington State in 2004 and appellant-husband commenced employment with an unrelated company.
11 (App. Opening Br.,³ p. 2; Resp. Opening Br., p. 1.)

12 During his employment with Immunex, appellant-husband received eight grants of
13 NQSOs as compensation for services rendered for each year, from 1996 through 2002. Appellant-
14 husband exercised various options while in California, working for Amgen, and then exercised various
15 other stock options while a resident of Washington, after terminating his employment with Amgen.
16 More precisely, appellant-husband exercised four stock option grants while in California and five stock
17 option grants after returning to Washington.⁴ (The options exercised in 2004 are detailed below.) (App.
18 Opening Br., p. 2.)

19 On the 2004 Form W-2 that appellant-husband received from Amgen, the form noted that
20 appellant-husband had income of \$2,710,511.44 from the exercise of stock options. Appellants filed a
21 part-year California resident return for 2004, indicating that they became nonresidents of California on
22 May 25, 2004. In addition, on their Schedule CA, California Adjustments schedule, appellants reduced
23

24 ² According to an Amgen press release, on December 17, 2001, the parties signed an agreement for Amgen's purchase of
25 Immunex. On July 15, 2002, the acquisition was completed with the Federal Trade Commission's approval of the purchase.

26 ³ For purposes of this hearing summary, appellants' appeal letter is referred to as their opening brief, their "opening brief" is
27 referred to as their reply brief, and their "response brief" is referred to as their supplemental brief.

28 ⁴ Appellant-husband received the following eight (8) grants of NQSOs on: (1) April 25, 1996; (2) February 13, 1997; (3)
February 24, 1998; (4) February 22, 1999; (5) February 17, 2000; (6) April 6, 2001; (7) February 11, 2002; and (8) July 15,
2002. Appellant-husband exercised the April 6, 2001 grant (Grant ID# 011790) in parts—a portion of this grant was
exercised while in California and a portion of the grant was exercised in Washington.

1 their income by \$2,435,937, relating to a portion of the NQSOs exercised, and reported California
2 taxable income of \$618,516 for the year. With this adjustment, appellants did not report any of the
3 income attributable to the NQSOs exercised after their move to Washington as California income.
4 (Resp. Opening Br., pp. 1-2.)

5 Upon review of appellants' 2004 return on audit, respondent concluded that appellants
6 should have reported a portion of the compensation from the exercise of the NQSOs which occurred
7 between June 16, 2004, and August 4, 2004—the NQSOs that were exercised after appellants moved to
8 Washington—as California source income. (Resp. Opening Br., p. 3.) In all, respondent determined
9 that appellants had additional California source income of \$1,006,404 resulting from appellant-
10 husband's exercise of the NQSOs, \$274,574 resulting from the exercise of NQSOs while appellants
11 were residents of California and \$731,830 from the exercise of NQSOs as residents of Washington (for
12 the options exercised between June 16, 2004, and August 4, 2004). (Resp. Opening Br., p. 4.)

13 Based upon the audit results mentioned above, on December 10, 2008, respondent issued
14 a Notice of Proposed Assessment (NPA) increasing appellants' California taxable income to \$3,159,782
15 and proposing an assessment of \$70,898 in tax. The NPA was protested and respondent subsequently
16 issued a Notice of Action on August 20, 2010, affirming the NPA. This timely appeal followed.

17 Overview

18 An Overview of Nonqualified Stock Options.⁵ The offering of nonqualified stock
19 options by corporations to their employees is a way for companies to compensate employees without
20 paying cash: corporations grant employees an option to purchase shares of stock in the corporation at a
21 fixed price. The incentive to an employee to participate in such a program is the potential increase in the
22 employer's stock value. Since the granting of such options is a form of compensation, an employee
23 must generally report ordinary income when options are exercised. The amount of ordinary income
24 recognized is the difference between the option price (i.e., the amount paid by the employee for the

25 ///

26 ///

27
28 ⁵ These options are also referred to as “nonstatutory stock options.”

1 shares) and the fair market value of the shares on the date of purchase (i.e., the exercise date).⁶

2 The NQSOs Granted to Appellant-Husband. As mentioned above, appellant-husband
3 received eight grants of NQSOs as compensation for services rendered for each year, from 1996 through
4 2002. The NQSOs were awarded pursuant to the Immunex stock option plan which specified that
5 options were subject to a five-year vesting schedule unless otherwise specified in the grant to the
6 individual. The vesting of options was conditioned upon an individual's continued employment with
7 Immunex. Shares that are unvested as a result of an employee's termination were subject to forfeiture.
8 (Resp. Opening Br., p. 2; Resp. Opening Br., Exhibit D.)

9 In 2004, as detailed below, appellant-husband exercised four stock option grants while in
10 California and five stock option grants after returning to Washington. Appellant-husband exercised the
11 following Immunex stock options while a resident of California, during his employment with Amgen
12 (App. Opening Br., p. 2; see Resp. Opening Br., Exhibit C):

Grant ID	Date Granted	Date Exercised	Income Reported on W-2
003697	4/25/1996	5/05/2004	\$100,053
006970	2/17/2000	5/05/2004	\$114,977
011790	4/06/2001	5/24/2004	\$34,257
978718	7/15/2002	5/24/2004	\$25,287
Total	-----	-----	\$274,574

13
14
15
16
17
18
19 Appellant-husband later exercised the following Immunex stock options while a resident of Washington,
20 after terminating his employment with Amgen (App. Opening Br., p. 2; see Resp. Opening Br., Exhibit
21 C):

22 ///

23 ///

24 ///

25 ///

26
27
28 ⁶ When the employee later sells the shares, he will have a short-term, or a long-term, capital gain or loss which is measured by the difference between the amount received on the sale and the employee's basis in the shares sold. Generally, the employee's basis in the shares will be the fair market value of the shares on the exercise date (which reflects the sum of the amount originally paid for the options plus the gain (ordinary income) previously recognized).

Grant ID	Date Granted	Date Exercised	Income Reported on W-2
005677	2/22/1999	6/16/2004	\$969,246.72
004705	2/24/1998	7/02/2004	\$752,155.20
004128	2/13/1997	7/14/2004	\$646,069.63
011790	4/06/2001	8/04/2004	\$65,829.96
013368	2/11/2002	8/04/2004	\$2,635.30
Total	-----	-----	\$2,435,936.70

In spite of the 2004 return filed, appellants now dispute both the NQSOs exercised while they were residents of California and the NQSOs exercised after they moved to Washington.

ISSUE 1: Whether respondent properly determined appellants' California source income resulting from the exercise of NQSOs.

Contentions

Appellants' Contentions

Appellants state that appellant-husband received stock options as an employee of Immunex for services rendered, from the beginning of his employment with Immunex in January 1994 through the end of his employment with the company in July 2002. Appellants contend that the stock option income can be split into two parts: the options that were exercised while residents of California and the options that were exercised as residents of Washington. (App. Opening Br., p. 3.)

As for the NQSOs exercised while appellants were California residents, appellants argue that these stock options were granted for services performed in the past, as appellant-husband did not receive his first stock option until he was with Immunex for two years. Appellants assert that the Immunex stock option grant awards given to appellant-husband state that "[t]his grant . . . is awarded to link your contribution and performance directly to the future of the company." As such, appellants argue that the stock options were granted so that the holder of the grant (appellant-husband) would be compensated for work previously performed. (App. Opening Br., p. 3.)

Appellants state that the last of the stock options granted to appellant-husband occurred on July 15, 2002, and that Immunex was purchased from Amgen on July 16, 2002. Appellants argue that it was Amgen's purchase of Immunex which forced appellant-husband to move to California. Appellants state the Amgen sent appellant-husband a letter offering him employment if he was willing

1 to relocate to California. Appellants assert that the job offer from Amgen reflected that appellant-
2 husband would have a different job title and duties with Amgen, which would be a demotion from
3 appellant-husband's previous job with Immunex. Appellants contend that this letter is evidence that the
4 stock options received was for work performed for Immunex, while a resident of Washington, and not
5 for services performed as an employee of Amgen. Based upon the above, appellants assert that the stock
6 options were granted to appellant-husband for past performance and that the stock options which were
7 exercised in California should not be taxable to California because the work was performed in
8 Washington. (App. Opening Br., p. 3; App. Reply Br., pp. 2-4.)

9 Appellants state that, if the Board decides that the NQSOs exercised while they were
10 residents of California are taxable in California, the portion of the income from the NQSOs which is
11 sourced to California should be limited by a method of allocation comparable to the method utilized by
12 respondent relating to the NQSOs exercised while in Washington. Appellants argue that the allocation
13 method should be changed to take into account all of the time that appellant-husband worked for
14 Immunex before he received his first stock option, as that period of time was largely the reason why
15 appellant-husband received the stock options. (App. Reply Br., p. 4.) Appellants assert that the
16 following allocation method should be used for the NQSOs exercised while residents of California
17 (App. Reply Br., p. 4):⁷

$$\frac{\text{California residency days from January 1994 to the exercise date}}{\text{Total number of days from January 1994 to the exercise date}}$$

18
19
20 Regarding the NQSOs exercised after appellants returned to Washington, appellants
21 contend that respondent relies upon California Code of Regulations, title 18, section (Regulation)
22 17951-5, subdivision (b), which provides in part:

23 If nonresident employees are employed in this State at intervals throughout the year, as
24 would be the case if employed in operating trains, boats, planes, motor buses, trucks, etc.,
25 between this State and other states and foreign countries, and are paid on a daily, weekly
26 or monthly basis, the gross income from sources within this State includes that portion of
27 the total compensation for personal services which the total number of working days
28 employed within the State bears to the total number of working days both within and
without the State. . . .

⁷ As mentioned above, appellant-husband began working for Immunex in January 1994.

1 Appellants assert that this regulation was directed to nonresident transient employees that are employed
2 in vocations that require them to enter in and out of California so that such individuals are not taxed
3 when they are actually outside of the state. Appellants contend that this regulation is clearly not
4 applicable in this instance. (App. Opening Br., pp. 3-4; App. Reply Br., p. 5.)

5 In contrast, appellants contend that they moved to California so that appellant-husband
6 could begin working at Amgen, an entity which is separate and distinct from Immunex. Appellants
7 assert that all of the stock options at issue here were received when appellant-husband was an employee
8 of Immunex for services performed while at Immunex. In addition, appellants state that they did not
9 move back and forth (as mentioned in the regulation), but that appellant-husband simply worked for
10 Amgen in California. Moreover, appellants state that they returned to Washington after the termination
11 of appellant-husband's employment with Amgen in 2004. (App. Opening Br., p. 4.)

12 Appellants state that Regulation 17951-5, subdivision (b), also refers to "allocat[ing] to
13 California that portion of the total compensation which is reasonably attributable to personal services
14 performed in this State." Appellants assert that respondent's position falters here because there was no
15 connection between the NQSOs which appellant-husband received as an employee of Immunex and the
16 services rendered in California while an employee of Amgen, as appellant-husband was offered a new
17 job with Amgen, with a different job title than the one he had at Immunex, and was forced to take a
18 demotion in accepting the position with Amgen. As such, appellants contend that none of the
19 compensation that appellant-husband received from Immunex was "reasonably attributable to personal
20 services performed in [California]," as the compensation from Immunex (i.e., the NQSOs granted)
21 would have been the same whether or not appellant-husband accepted the job offer from Amgen and that
22 Immunex and Amgen were two separate companies. In addition, appellants assert that appellant-
23 husband's performance at Amgen did not bear on the option price of the NQSOs granted to him.
24 Appellants contend that the "strike price" of the NQSOs was established when the options were granted
25 and then repositioned when Amgen's purchase of Immunex was finalized. (App. Reply Br., p. 5.)

26 In the alternative, appellants contend that even if Regulation 17951-5, subdivision (b),
27 were to apply, the allocation method which respondent utilized for its calculations has no legal basis and
28 is arbitrary and capricious. In fact, appellants contend that there is no rule regarding a method of

1 allocation. In addition, appellants assert that respondent's method of allocation does not take into
2 account the two years (starting with January 1994) that appellant-husband initially performed services at
3 Immunex in order to be granted stock options in the first place. (App. Opening Br., p. 4; App. Reply
4 Br., p. 6.) Appellants argue that, if an allocation were to apply, the following allocation method⁸ should
5 be used for the NQSOs exercised while they were nonresidents (App. Reply Br., p. 6):

$$\frac{\text{California residency days from January 1994 to the exercise date}}{\text{Total number of days from January 1994 to the exercise date}}$$

6
7
8 Appellants argue that respondent failed to provide a reasonable legal or factual explanation as to why the
9 allocation should not include all of the days that appellant-husband worked in Washington for Immunex.
10 Appellants acknowledge that one of the reasons stock options are given to employees includes a
11 "retention incentive." Consequently, appellants contend that appellant-husband would never have
12 received stock options in the first place if he had not provided years of loyal service to Immunex before
13 he was given his first NQSOs. Appellant point out that the stock option summary provides that
14 employees who participate in the plan are selected by the plan administrator, which implies that
15 inclusion in the plan is based upon work performance.⁹ (App. Reply Br., p. 6.)

16 Appellants also contend (citing *H.P. Hood & Sons, Inc. v. Du Mond* (1949) 336 U.S. 525,
17 537-538) that California's taxation of stock options received by an employee of a Washington
18 corporation, who moves to California to work for a separate California corporation, and who then
19 exercises those options as a resident of Washington, is a violation of the Dormant Commerce Clause.
20 Appellants assert (citing *C&A Carbone, Inc., v. Town of Clarkstown* (1994) 511 U.S. 383) that the test is
21 to weigh the burden on interstate commerce in relation to the local benefits and that, in this instance, the
22 burden of the taxation on appellant-husband clearly outweighs the benefit of the additional revenue to
23 California. (App. Reply Br., p. 7.)

24 Finally, while respondent argues that there is no connection between appellant-husband's
25

26 ⁸ Staff notes that this is the same allocation method which appellants propose for the options exercised while appellants were
27 residents of California.

28 ⁹ The 1999 plan summary provides that (Resp. Opening Br., Exhibit D, p. 3):
"The Plan Administrator has the full and exclusive power to interpret the Plan and to establish the rules for its operation,
including the power to select the individuals to be granted options under the Plan . . ."

1 performance and the issuance of the NQSOs, appellants reassert that the NQSOs were granted for prior
2 performance. Appellants assert that the option award given to appellant-husband clearly references
3 appellant-husband's past performance as the key to the granting of the stock options.¹⁰ Appellants state
4 that they agree with respondent—that the NQSOs vested at the time Immunex was sold to Amgen.
5 However, appellants disagree with respondent's position that, because the stock options continued to
6 hold value after the acquisition, this became the definitive link between appellant-husband's services
7 between Immunex and Amgen. Appellants instead contend that the NQSOs continued to hold value
8 because Amgen needed to retain Immunex employees and that this was the only way to lure these
9 employees to California. In addition, appellants state that once appellant-husband began work for
10 Amgen, he was eventually provided NQSOs for his work at Amgen. In the alternative, if the Board
11 agrees with respondent's position, appellants contend that a different allocation methodology should be
12 utilized to account for the years appellant-husband worked for Immunex prior to his first receipt of
13 NQSOs. (App. Reply Br., p. 7; App. Supp. Br., p. 2.)

14 Respondent's Contentions

15 Respondent states that it calculated appellants' California source income by multiplying
16 appellant-husband's gain from the exercise of the NQSOs by the ratio of his California days from the
17 grant date to the exercise date of the NQSOs over the total days during the same period of time.
18 Respondent determined that appellants had additional California source income of \$1,006,404 resulting
19 from appellant-husband's exercise of the NQSOs, \$274,574 resulting from the exercise of NQSOs while
20 appellants were residents of California and \$731,830 from the exercise of NQSOs as residents of
21 Washington. (Resp. Opening Br., p. 4.) Respondent states that it calculated appellants' income
22 attributable to California, after they became nonresidents of California (i.e., the \$731,830 of income
23 from NQSOs from Washington), by prorating the stock options exercised as follows (Resp. Opening Br.,
24 p. 4):

25 ///

26 _____
27 ¹⁰ A stock option grant award letter, dated March 31, 1998, states in part that "Congratulations! As part of your total rewards
28 for contributions to Immunex in 1997, the Board of Directors approved your stock option grant . . . This grant is a valuable
component of your total compensation and is awarded in order to link your contribution and performance directly to the
future of the company." (App. Supp. Br., Exhibit A.)

Date Granted	Calif. ¹¹ Days	Wash. Days	Total Days	Calif. %	Total Taxable Gain	Total Taxable Calif. Source Gain
Feb. 13, 1997	421	1,322	1,743	24%	\$646,070	\$156,050
Feb. 24, 1998	421	1,074	1,495	28%	\$752,155	\$211,811
Feb. 22, 1999	421	835	1,256	34%	\$969,247	\$324,883
April 6, 2001	421	327	748	56%	\$65,830	\$37,051
Feb. 11, 2002	421	124	545	77%	\$2,635	\$2,035
Totals	---	---	---	---	\$2,435,937	\$731,830

Respondent states that the taxation of NQSOs is governed by IRC section 83(a), which provides that a taxpayer does not recognize gain when NQSOs are granted. Instead, respondent states that, under the statute, a taxpayer recognizes taxable compensation to the extent that the fair market value of the stock exceeds the option price when the NQSOs are exercised. (Resp. Opening Br., p. 5.)

Respondent asserts that it is well-established (citing *Commissioner v. LoBue* (1956) 351 U.S. 243 and *Appeal of Charles W. and Mary D. Perelle*, 58-SBE-057, Dec. 17, 1958) that the gain from the exercise of NQSOs is characterized as compensation for personal services and that respondent properly determined that the gain from appellant-husband's NQSOs was compensation for services. Respondent notes that appellant-husband performed services in California and exercised NQSOs as a California resident, and also exercised NQSOs as a California nonresident.¹² (Resp. Opening Br., p. 5.)

Further, respondent asserts that, because appellant-husband performed services in California for his employer during the grant-to-exercise period of the NQSOs, a portion of the compensation from the NQSOs exercised once appellants became nonresidents is California source income as well (citing *Appeal of Robert C. and Marian Thomas*, 55-SBE-006, April 20, 1955; *Appeal of Janice Rule*, 76-SBE-099, Oct. 6, 1976; and *Appeal of Karl Bernhardt*, 84-SBE-153, Nov. 14, 1984.) Respondent argues that R&TC section 17041 provides that the California taxable income of a California nonresident includes gross income derived from sources within California in accordance with R&TC

¹¹ The Appeals Division staff (staff) recognizes that there were more than 421 days between August 2002 when appellants moved to California and when they left California in 2004 (as appellant-husband left his employment with Amgen in May 2004). Staff assumes that respondent only counted appellant-husband's work days in California and Washington. Such a methodology would be consistent with the method described in Franchise Tax Board Publication 1004 (revised October 2007), *Stock Option Guidelines*, p. 6.

¹² As such, respondent asserts, pursuant to R&TC section 17041, subdivision (i)(1)(A), that the \$274,574 of gain relating to the NQSOs exercised while appellants were California residents is taxable as California income.

1 section 17951. (Resp. Opening Br., pp. 5-6.) Specifically, respondent states that Regulation 17951-5,
2 subdivision (b), provides in part:

3 If the employees are paid on some other basis, the total compensation for personal
4 services must be apportioned between this State and other States and foreign countries in
5 such a manner as to allocate to California that portion of the total compensation which is
6 reasonably attributable to personal services performed in this State.

7 In citing the *Appeal of James B. and Linda Pesiri*, 89-SBE-027, Sept. 26, 1989,
8 respondent contends that its reasonable allocation must be based upon the facts and circumstances
9 present in each case and that, consistent with the regulation, respondent applied a reasonable method of
10 allocation to determine the amount of California source income resulting from the exercise of the
11 NQSOs. Respondent states that it multiplied appellant-husband's compensation by a ratio of his
12 California days from the grant date to the exercise date over the total days during the same period as
13 follows (Resp. Opening Br., p. 6):

$$\frac{\text{California days from grant date to exercise date}}{\text{Total days from grant date to exercise date}}$$

14
15 Respondent states that it calculated the California days during the grant-to-exercise period, starting with
16 the date of the grant of each stock option and ending on the date of the exercise of the NQSO.
17 Respondent argues that (citing the *Appeal of Melvin A. and Adele R. Gustafson*, 88-SBE-027, Nov. 29,
18 1988), when it applies a formula for the allocation of income, the taxpayer bears the burden of showing
19 that the application is intrinsically arbitrary or that it produced an unreasonable result. In response to the
20 argument that the allocation is arbitrary and capricious, respondent argues that appellants failed to
21 explain how respondent's allocation did not reflect appellant-husband's compensation for services
22 performed in California. (Resp. Opening Br., p. 6.)

23 Respondent notes that appellants have argued the following: (1) that the NQSOs were
24 granted prior to appellants' move to California and were intended as compensation for prior services
25 performed in Washington and should not be sourced to California; and (2) that the NQSOs were granted
26 by Immunex, a company which is separate and distinct from Amgen and, because all of the services
27 performed in California were for Amgen, the NQSOs were entirely sourced to Washington. (Resp.
28 Opening Br., p. 6.) Respondent argues that appellants' arguments fail because those arguments do not

1 take into account why a company offers alternative forms of compensation such as stock options.
2 Respondent contends that, because NQSOs vest over a period of years, such options provide an
3 incentive for employees to remain with their employer and to continue working hard on the company's
4 behalf so the company's stock price will rise. As such, respondent argues that it does not benefit an
5 employee to terminate his employment with a company before his NQSOs vest because the employee
6 may forfeit rights to this compensation (i.e., NQSOs). Consequently, respondent contends that it was in
7 appellant-husband's best interest to continue with Immunex and to be a productive employee. (Resp.
8 Opening Br., p. 7.)

9 Respondent contends that this logic is apparent based upon the language of the stock
10 option plan, which provides that (Resp. Opening Br., p. 7; Resp. Opening Br., Exhibit D, p. 3):

11 The purpose of the Plan is to enhance the long-term shareholder value of Immunex by
12 offering opportunities to selected individuals to participate in Immunex's growth and
13 success. The Plan's purpose is also to attract and retain participant's services and to
14 encourage them to acquire and maintain ownership in Immunex.

14 Respondent asserts that the language of Immunex's plan is entirely prospective and there is no
15 indication that the NQSOs granted to appellant-husband were part of his compensation for prior
16 performance. (Resp. Opening Br., p. 7.)

17 In addition, respondent contends that appellants' argument that the options should not be
18 sourced to California (because the options were granted by Immunex, not Amgen, and appellant-
19 husband's performance of services in California for Amgen are disconnected from the options) is
20 illogical. Respondent asserts that Amgen assumed Immunex's responsibilities with regard to the
21 NQSOs in full at the time of the acquisition, as the stock option plan provides that, in case of a change
22 of control of the company, the vesting of outstanding options would either accelerate or the outstanding
23 options would be replaced with options for the purchase of common stock in the successor
24 corporation.¹³ Here, respondent states that appellant-husband received options (and later purchased

25
26
27 ¹³ The 1999 plan summary provides that (Resp. Opening Br., Exhibit D, pp. 7-8):
28 "If certain corporate change-of-control transactions occur (such as a merger, consolidation, reorganization or liquidation of
Immunex), your options vesting schedule will automatically accelerate and your option will become 100% vested
immediately prior to the corporate transaction. However, options will not accelerate if a successor corporation assumes the
outstanding options. If this happens, outstanding options will be replaced with options to purchase common stock of the

1 stock) in the successor corporation, Amgen. As such, respondent contends that appellant-husband's
2 performance of services for Amgen in California is a continuation of the services that he was performing
3 for Immunex in Washington in exchange for compensation in the form of the NQSOs. Consequently,
4 respondent argues that the NQSOs cannot be disconnected from appellant-husband's performance of
5 services for Amgen as the NQSOs are inextricably linked to his performance of services for Amgen.
6 Otherwise, respondent asserts that the NQSOs would have vested immediately and have been available
7 for exercise to appellant-husband at the time of Amgen's takeover of Immunex. In addition, respondent
8 argues that appellant-husband had to continue working for Amgen to receive the benefit of the unvested
9 NQSOs which, at a minimum, links the unvested NQSOs to appellant-husband's performance of
10 services for Amgen in California. (Resp. Opening Br., pp. 7-8; Resp. Reply Br., pp. 2-3.)

11 As for appellants' argument that the NQSOs were compensation for past services
12 performed solely for Immunex, respondent argues that California is not taxing Washington source
13 income. Respondent asserts that there is nothing in the stock option plan which supports the position
14 that the NQSOs were granted solely for compensation for services performed in Washington and were
15 not for future services. Respondent states that (1) appellants reference the stock option plan, which
16 provides that participants in the plan are chosen by the plan administrator, and (2) appellants contend
17 that this section of the plan implies that inclusion in the plan is based upon work performance.
18 Respondent disagrees and contends (1) that any number of factors, such as prior work experience at
19 other companies or an individual's level of education, could have been implicit in the plan
20 administrator's decisions and (2) that it cannot be assumed, without an explicit statement of the intent
21 behind an option award, that NQSOs were granted as compensation for prior services. (Resp. Reply Br.,
22 p. 2.)

23 Finally, respondent disagrees with appellants' assertion that there has been a violation of
24 the Dormant Commerce Clause of the United States Constitution. Respondent states (citing *Oregon*
25 *Waste Systems v. Department of Environmental Quality* (1994) 511 U.S. 93, 99) that the United States
26 Supreme Court defines discrimination under the Dormant Commerce Clause as the "differential
27

28 successor corporation, and, unless the Board [of Immunex] decides otherwise, options will retain their original vesting
schedule."

1 treatment of in-state and out-of-state economic interests that benefits the former and benefits the latter.”
2 Respondent argues that it is not treating in-state interests differently than out-of-state interests but is
3 simply taxing the income appellants received for personal services performed in California. Further,
4 respondent states that no separate or distinct tax rate or other discriminatory treatment has been applied
5 to appellants as California nonresidents and that appellants were not taxed differently from any other
6 taxpayer who performs personal services for compensation in California. Respondent concludes by
7 noting (and citing the *Appeal of Aimor Corp.*, 83-SBE-221, Oct. 26, 1983) that the Board has a policy of
8 abstention from deciding constitutional issues in appeals that come before the Board. (Resp. Reply Br.,
9 pp. 1-3.)

10 Applicable Law

11 Burden of Proof

12 The FTB’s determination is presumed to be correct, and a taxpayer has the burden of
13 proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael E. Myers*, 2001-SBE-
14 001, May 31, 2001; *Appeal of Robert E. and Argentina Sorenson*, 81-SBE-005, Jan. 6, 1981.)
15 Unsupported assertions are not sufficient to satisfy a taxpayer’s burden of proof. (*Appeal of Aaron and*
16 *Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) In the *Appeal of Melvin A. and Adele R. Gustafson*, 88-
17 SBE-027, Nov. 29, 1988, the Board held that, in the context of reviewing respondent’s method of
18 allocating a taxpayer’s income from services, the taxpayer bears the burden of showing that the
19 application is intrinsically arbitrary or that it produces an unreasonable result.

20 California Taxation of Part-Year Residents

21 R&TC section 17041, subdivision (b), imposes a tax upon the California-source income
22 of part-year residents for periods when they are a nonresident and upon their income from all sources for
23 periods when they are a California resident. The rate of tax on part-year residents is determined by
24 taking into account the taxpayer’s worldwide income. (See *Appeal of Louis N. Million*, 87-SBE-036,
25 May 7, 1987.) The method does not tax out-of-state income that is received while a taxpayer is not a
26 resident of California, but merely takes the out-of-state income into consideration in determining the tax
27 rate that should apply to California income. (*Id.*) The purpose of this method is to apply the graduated
28

1 ///

2 ///

3 tax rates to all persons - not just to those who live in California for the full tax year.¹⁴ (*Id.*)

4 Compensation for personal services is sourced to the place where the services are
5 performed. (Cal. Code Regs., tit. 18, § 17951-2; *Appeal of Robert C. and Marian Thomas*, 55-SBE-006,
6 April 20, 1955.) In addition, the total compensation for personal services must be apportioned between
7 California and other states and foreign countries in which the individual was employed in such a manner
8 as to allocate to California that portion of the total compensation which is reasonably attributable to
9 personal services performed in California. (Cal. Code Regs., tit. 18, §17951-5, subd. (b).)

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

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

15 "Restricted stock" exists when a taxpayer's interest in the property is subject to a
16 "substantial risk of forfeiture" and can't be freed of that risk. (Int.Rev. Code, § 83.) Income from
17 restricted stock is deferred until the interest in the property either is no longer subject to that risk or
18 becomes transferrable free of the risk, whichever occurs earlier. (Int.Rev. Code, § 83.) A substantial
19 risk of forfeiture exists where rights in property that are transferred are conditioned, directly or
20 indirectly, upon the future performance (or refraining from performance) of substantial services by any
21 person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of
22 forfeiture is substantial if such condition is not satisfied. (Int.Rev. Code, § 83(c)(1).) Whether a risk of

23 ///

24 _____
25 ¹⁴ The fundamental fairness and constitutionality of the above-described method of taxing the California-sourced income of
26 part-year residents has been upheld by New York's highest court, and the United States Supreme Court refused to hear an
27 appeal of the New York decision. (*Brady v. New York* (1992) 80 N.Y. 2d 596 cert. den. (1993) 509 U.S. 905.) The *Brady*
28 court reasoned that similarly-situated taxpayers were those with the same total income. For example, a nonresident earning
\$20,000 in New York, but with \$100,000 of total income, should be taxed on the \$20,000 of New York-sourced income at
the same rate as a New York resident with \$100,000 of total income (and not at the same rate as a New York resident with
\$20,000 of total income).

1 ///

2 ///

3 forfeiture is substantial depends on the facts and circumstances. (Treas. Reg. § 1.83-3(c)(1).)¹⁵

4 In *Commissioner v. LoBue, supra*, the United States Supreme Court held that where stock
5 options given by a corporation to any employee were not transferable and the employee's right to buy
6 stock under the stock option plan was contingent upon the individual remaining an employee of the
7 company until the stock options were exercised, the taxable gain to the employee should be measured as
8 of the time the options were exercised and not the time the options were granted. The Court rejected the
9 taxpayer's argument that a stock option transaction should be treated as a mere purchase of a proprietary
10 interest in the corporation to which no taxable gain was realized in the year of the purchase. The Court
11 stated that a stock option given to an employee as compensation was not a mere purchase of an interest
12 or an arm's length transaction between strangers, but an arrangement by which an employer transferred
13 valuable property to its employees in recognition of their services; thus, the stock options given should
14 be treated as taxable compensation, not the mere acquisition of a property interest.

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

21 . . . the uniform Treasury practice since 1923 has been to measure the compensation to
22 employees given stock options subject to contingencies of this sort by the difference
23 between the option price and the market value of the shares at the time the option is
exercised And in its 1950 Act affording limited tax benefits for restricted stock

24 ¹⁵ 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
impliedly conditioned upon the successful completion of the underwriting, the stock is subject to a substantial risk of
forfeiture.
27 (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.
28 (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 option plans, Congress adopted the same kind of standard for measurement of gains
2 Under these circumstances, there is no reason for departing from the Treasury practice.
3 The taxable gain to LoBue should be measured as of the time the options were exercised
4 and not the time they were granted.
5 (*Commissioner v. LoBue, supra*, at 249.) Thus, under the holding in *LoBue*, the taxable gain to an
6 employee who received a restricted stock option in one year and then sold it at a profit in a subsequent
7 year should be measured as of the time the option was exercised and not the time it was granted.

8 In the *Appeal of Charles W. and Mary D. Perelle, supra*, the taxpayer, who was then a
9 California resident, entered into an employment contract in July 1944 by which he agreed to work
10 exclusively for his employer corporation for a period of five years. In September 1944, he received a
11 five-year option to purchase 10,000 shares of stock at a market price designated by him. In December
12 1945, he ceased to work for the employer. In March or April of 1946, he was hired by a Michigan
13 employer. In July 1946, he moved to Michigan. In September of that year, he sold his stock option
14 back to the corporation for \$250,000. On its books, the corporation treated this sum as compensation.
15 Relying upon the United States Supreme Court's decision in *LoBue*, the Board held that the gain on the
16 sale of the option was compensation for services. Because the services were performed in California,
17 the gain was taxable by California despite the taxpayer's status as Michigan residents at the time they
18 sold their option.

19 In the *Appeal of Earl R. and Alleene R. Barnett* (80-SBE-122), decided by the Board on
20 October 28, 1980, the taxpayer had been granted employee stock options while he resided in Canada.
21 He subsequently retired, and then moved to California. The taxpayer asserted that the stock options
22 were received for services rendered in Canada, that his rights to the income accrued while he was a
23 Canadian resident, and that the compensation income from the stock option was not taxable by
24 California. Respondent contended that income was not recognized until he exercised the option, at
25 which point he was a California resident and, therefore, the income was taxable by California.

26 The Board noted that California taxes the entire income of its residents, regardless of
27 source, and ruled in favor of respondent. It stated that, until the option was exercised, there was
28 substantial uncertainty about the amount of income that would be received and that the income therefore
accrued when he exercised the option, which was when he was a California resident. The Board further

1 stated that *Perelle* was distinguishable, because the income involved in *Perelle* was from a California
2 source and was therefore taxable regardless of whether the taxpayer was a resident of California.

3 ///

4 Reasonable Apportionment Method

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

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

24 In *Appeal of C. J. and Helen McKee* (68-SBE-023), decided by the Board on May 7,
25 1968, the taxpayer was an Oregon resident who also operated a business in Oregon. During the busy
26 season, when the company generally earned its net profits, the taxpayer worked in Oregon. During the
27

28 ¹⁶ 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 off-season, when the company generally operated at a loss, the taxpayer spent time in California. The
2 taxpayer's salary, however, continued throughout the entire year, including the off-season. The taxpayer
3 also received annual bonuses, apparently based upon corporate profits. On his return, the taxpayer
4 sourced one-half of his salary to California, but none of his annual bonus to California. Despite the fact
5 that the taxpayer spent approximately one-half of each year in California, the Board found that none of
6 the bonus could reasonably be sourced to California because the bonus was based upon the corporation's
7 net profits and during the off-season months the corporation generally operated at a loss while the
8 taxpayer was in California. The Board noted that the corporation's net profits were earned during the
9 time when the taxpayer was present in Oregon and actively engaged in managing the business. Thus,
10 the Board determined that the bonus was attributable to sources outside of California.

11 The Franchise Tax Board's Publication 1004 (revised October 2007), *Stock Option*
12 *Guidelines*, states, in part, the following:

13 If you performed services for the corporation both within and outside California[,] you
14 must allocate to California that portion of total compensation reasonably attribute[able] to
15 services performed in this state [citing Regulation 17951-5, subdivision (b)].

16 One reasonable method is an allocation based on the time worked. The period of time
17 you performed services includes the total amount of time from the grant date to the
18 exercise date (or the date your employment ended, if earlier).

19 The allocation ratio is:

$$\frac{\text{California workdays from grant date to exercise date}}{\text{Total workdays from grant date to exercise date}}$$

20 Income taxable by California = Total stock option income x Allocation ratio.

21 Constitutionality of the Assessment

22 Regarding the issue of constitutionality, the United States Constitution gives Congress
23 the power to regulate commerce between the states. (U.S. Const., art. I, § 8, cl. 3.) However, the
24 California Constitution prohibits, in pertinent part, an administrative agency from refusing to enforce a
25 statute unless an appellate court has determined that the statute is unconstitutional. (Cal. Const., art. III,
26 § 3.5.) Furthermore, this Board has a well-established policy of abstaining from deciding constitutional
27 issues. (Cal. Code Regs., tit. 18, § 5412, subd. (b); *Appeal of Aimor Corp.*, 83-SBE-221, Oct. 26, 1983;
28 *Appeal of Vortex Manufacturing Co.*, 30-SBE-017, Aug. 4, 1930.) This policy is based upon the

1 absence of any specific statutory authority which would allow respondent to obtain judicial review in
2 such cases and upon our belief that judicial review should be available for questions of constitutional
3 importance. (*See Appeal of Aimor Corp., supra; Appeal of Vortex Manufacturing Co., supra.*)

4 STAFF COMMENTS

5 Staff notes that in the part-year return filed, appellants reported as California income the
6 NQSOs exercised while California residents. However, in this appeal, appellants now contest that these
7 NQSOs should not be subject to tax by California.

8 Appellants should be prepared to address why, the NQSOs exercised while residents of
9 California, should not be sourced to California. Appellants should also be prepared to explain how
10 respondent's apportionment method, using work days from the grant-to-exercise date, is unreasonable
11 and why the alternative method which appellants propose, relating to the NQSOs exercised after their
12 return to Washington State, is a more reasonable application of Regulation 17951-5, subdivision (b).

13 **ISSUE 2: Whether respondent properly calculated the rate of taxation, as required by R&TC**
14 **section 17041, subdivision (b), and included the appropriate amounts of appellants'**
15 **income in such calculation.**

16 As a result of respondent's adjustments to appellants' California source income,
17 appellants' tax rate increased from 8.75 percent to 9.17 percent.

18 Contentions

19 Appellants' Contentions

20 Appellants disagree with the increase in the tax rate (from 8.75 percent to 9.17 percent),
21 as a result of the proposed increase in appellants' California income. Appellants contend that the tax
22 rate applied to their California taxable income should not change. (App. Opening Br., p. 4; App. Reply
23 Br., p. 8.)

24 Respondent's Contentions

25 Respondent states that appellants argue the following: that the tax rate applied here is
26 erroneous because the income associated with the NQSOs is not sourced to California and, thus, not
27 subject to tax in California. Respondent states that it is appropriate to examine appellants' income from
28 all sources, as appellants appear to dispute the calculation of the tax rate. Respondent states that R&TC

1 section 17041, subdivision (b), imposes tax on the taxable income of nonresidents and part-year
2 residents who receive income from sources in California, but that tax is not imposed on a nonresident's
3 or part-year resident's income from sources outside of California. (Resp. Opening Br., p. 8.)

4 Respondent states that the California Method is used to determine the income of a
5 nonresident or a part-year resident and that this methodology utilizes a taxpayer's worldwide income to
6 determine the rate of taxation, but does not tax the taxpayer's non-California source income.¹⁷

7 Respondent asserts that this method of determining taxation was upheld in the *Appeal of Louis N.*
8 *Million, supra*, and in the *Appeal of Dennis L. Boone*, 93-SBE-015, Oct. 28, 1993. Under the California
9 Method, respondent states that appellants' tax rate is based upon their income from all sources, which
10 properly included the gain from NQSOs exercised during 2004 and that respondent properly applied the
11 California Method to determine appellants' tax rate. (Resp. Opening Br., pp. 8-9.)

12 Applicable Law

13 California Method of Taxation

14 To properly assess a part-year resident's tax liability, that taxpayer is required to calculate
15 three ratios in accordance with R&TC section 17041, subdivision (b). These ratios, and the way these
16 ratios are calculated and applied to a taxpayer's income, are as follows. First, to calculate the percentage
17 of itemized deduction or a prorated standard deduction, a part-time resident's California AGI is divided
18 by the total AGI. The resulting rate is then applied to the itemized deduction to find the prorated
19 deduction. Next, to calculate the rate for California, a part-time resident's tax on his total income is
20 calculated as if the taxpayer was a California resident, and then divided by the taxpayer's total taxable
21 income as if the taxpayer was a California resident. The resulting rate is then applied to the part-time
22 resident's California taxable income to determine the taxpayer's California tax. Finally, to calculate the
23 percentage of credits allowed on a part-time resident's California return, the California taxable income is
24

25 ¹⁷ Respondent describes the application of the California Method as follows (Resp. Opening Br., p. 8): A taxpayer's total
26 adjusted gross income (AGI) from all sources inside and outside of California is first determined. Then, taxable income is
27 calculated by subtracting the taxpayer's itemized deductions or standard deduction from AGI. Tax on the total taxable
28 income is then determined. The California tax rate is calculated by dividing the amount of tax computed by the taxpayer's
total taxable income.

Once the taxpayer's California tax rate is determined, California AGI is calculated by including income from all sources
within California. California itemized deductions are then subtracted to arrive at the California taxable income. Finally, the
California taxable income is then multiplied by the California tax rate to determine the amount of tax.

1 divided by the total taxable income. The resulting rate is then applied to the total exemption amount to
2 find the prorated credits.

3 ///

4 STAFF COMMENTS

5 Appellants should be prepared to address, based upon the amounts included in the
6 proposed determination, any errors that respondent made in the calculation of the applicable rate of tax.
7 Staff notes that, if the Board concludes that (1) respondent made no errors in its calculation of the
8 applicable rate of tax in its proposed determination and (2) that the inclusion of the NQSOs as
9 determined by respondent is appropriate (as discussed in Issue 1), the Board should conclude that
10 respondent made no error in the calculation of the rate of tax. Otherwise, the Board should find for
11 appellants on this issue and should direct respondent to calculate the rate of tax, consistent with the
12 California Method, based upon the amounts includable in appellants' income as determined in Issue 1 of
13 this appeal.

14 ///

15 ///

16 ///

17 Gaeto_ase.doc

18

19

20

21

22

23

24

25

26

27

28