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

10 In the Matter of the Appeal of: ) **HEARING SUMMARY<sup>2</sup>**  
11 ) **PERSONAL INCOME TAX APPEAL**  
12 **KEVIN E. GERTNER AND** ) Case No. 476333  
13 **BERTA MARTINEZ<sup>1</sup>** )  
14 \_\_\_\_\_ )

	<u>Year</u>	<u>Proposed Assessment</u>
	2003	\$67,844

18 Representing the Parties:

20 For Appellant: Edwin P. Antolin, Attorney at Law  
21 For Franchise Tax Board: Jeanne P. Sibert, Tax Counsel III

23 QUESTIONS: (1) Whether respondent properly determined that the subject sale of appellants' stock  
24 occurred in 2002 when appellants were residents of California and thus gain on the  
25 sale was taxable by California.

27 <sup>1</sup> Appellants currently reside in Switzerland.

28 <sup>2</sup> This appeal was originally scheduled for a hearing at the May 25-26, 2010 Board meeting but was postponed at the request of appellants.

1 (2) If the gain in issue is properly sourced to California, whether appellants were  
2 taxable on that gain in 2002 so that respondent should have issued a proposed  
3 assessment of additional tax for 2002, rather than 2003.

4 HEARING SUMMARY

5 Factual and Procedural Background

6 On September 1, 1999, appellant<sup>3</sup> was hired as the “Director of R&D” of Leap Medical,  
7 Inc. (Leap), pursuant to an employment agreement which included provisions for a base salary of  
8 \$80,000 and for the President/Chief Executive Officer to recommend that Board of Directors grant  
9 appellant an option to purchase 800,000 shares of Leap common stock exercisable according to Leap’s  
10 standard exercise schedule. Thereafter, appellant entered into a Restricted Stock Purchase Agreement  
11 (Agreement) with Leap under which he acquired 800,000 restricted shares of Leap common stock on  
12 November 5, 1999. On September 7, 2000, appellant and Leap executed an “Addendum to Restricted  
13 Stock Purchase Agreement” (Addendum) that amended the original Agreement by adding a vesting  
14 requirement by which appellant’s shares would vest over a four-year period beginning on November 5,  
15 1999. 25 percent would vest on the first anniversary of the Agreement and 1/48th of the shares would  
16 vest each month thereafter. The Addendum also gave Leap the option to repurchase appellant’s  
17 unvested shares at the price paid by appellant in the event appellant ceased to be an employee or  
18 consultant with Leap for any reason. Leap’s option to repurchase lapsed as the shares vested. (Resp.  
19 Open.Br., pp. 1-2.)

20 After entering into the Addendum, appellant filed an Internal Revenue Code (IRC)  
21 section 83(b) election for the 800,000 shares of common stock on September 14, 2000. Appellant’s  
22 reported fair market value of the shares was \$0.001 per share at the time of transfer and the amount  
23 appellant paid was \$0.001 per share. Based on that election, appellant was not required to include the  
24 value of the stock in his gross income for 2000 because the compensation element of the restricted stock  
25 closed. Thus, appellant would no longer be taxed when the restrictions on the stock lapsed, but instead  
26 would be taxed on any resulting capital gain when he sold the stock. On December 12, 2000, Leap  
27

28 <sup>3</sup> “Appellant” refers to appellant-husband Kevin Gertner.

1 changed its name to Avantec Vascular Corporation (Avantec). (Resp. Open. Br., p.2.)

2 In 2002 Goodman Co., Ltd. (Goodman), Avantec's Japanese distributor and a 19 percent  
3 shareholder, began negotiations to acquire Avantec. Appellant stated in a letter to respondent dated  
4 September 26, 2008, that he was very involved in negotiating the Goodman acquisition of Avantec. On  
5 May 9, 2002, Avantec entered into a Letter of Intent (LOI) expressing the basic terms and conditions in  
6 connection with Goodman's acquisition of Avantec. The LOI describes a two-step process through  
7 which Goodman would acquire Avantec. First, Goodman purchased an "Option" for a cost of \$4.00 per  
8 share, not to exceed 13,497,775 shares, and deposited an amount into the cash escrow account on  
9 May 16, 2002. By purchasing the Option, Goodman could then choose between (1) 100% Option:  
10 Goodman would purchase all of Avantec's shares; (2) Share Option: Goodman would purchase 20  
11 percent of the Avantec shares; or (3) 0% Option: Goodman would purchase none of the shares and the  
12 sellers would retain the \$4.00 per share and their Avantec shares. (Resp. Open. Br., pp.2-3; App. Open.  
13 Br., exh. A, p.2 and exh. C.)

14 On May 15, 2002, appellants signed the Form of Acknowledgement and Consent,  
15 acknowledging they were parties to the May 15, 2002, Purchase Agreement by and among Goodman,  
16 Avantec, and the Sellers, consenting to the sale. A memorandum dated May 29, 2002 (memorandum),  
17 from Avantec's President and Chief Executive Officer Motasim Sirhan confirms that Goodman  
18 "purchased an option for \$4.00 per share from each Avantec shareholder and option holder that signed  
19 the agreement." The memorandum also states that "holders of more than 90% of the outstanding stock  
20 of Avantec (the 'Selling Stockholders') have already entered into an agreement to sell their shares to  
21 Goodman. On behalf of the Company, I ask you to agree to join us in effecting this transaction with  
22 Goodman by signing up to the agreement." (Resp. Open. Br., p. 3, exh. D.)

23 The memorandum recited that under the 100% Option, Goodman agreed to pay "an  
24 additional \$6.00 per share in cash to each Selling Stockholder for an aggregate payment of \$10.00 per  
25 share." Under paragraph III titled "Option Price" the memorandum recites that payment of the Option  
26 price "for unvested stock options and common stock subject to repurchase shall be held in the cash  
27 escrow account until the shares underlying such options vest and such options are exercised or the  
28 repurchase rights lapse, as the case may be." (App. Open. Br., exh. D.) Goodman subsequently chose

1 the 100% Option and announced it completed its acquisition of all the Avantec stock on July 30, 2002.

2 Appellants were California residents until May 31, 2003, when they relocated to Nevada.  
3 After the move, appellant continued to serve as Director of Research and Development/Quality Affairs  
4 with Avantec. (Resp. Open. Br., exh. A, p.2.) Appellant received four payments of \$375,000 from his  
5 sale of the Avantec stock on January 16, April 10, July 10 and October 14, 2003. Appellant terminated  
6 his employment with Avantec on November 14, 2003. Appellants timely filed a 2003 California  
7 Nonresident or Part-Year Resident Income Tax Return (540NR) reporting California taxable income of  
8 \$1,009,823. Appellants reported only the sales of the Avantec stock on January 16 and April 10, each  
9 with a sales price of \$375,000 and a basis of \$107, resulting in gain of \$374,893 per sale. Appellants  
10 excluded the two payments of \$375,000 each received on July 10 and October 14, after they became  
11 Nevada residents. (Resp. Open. Br., pp. 3-4.)

12 Respondent audited appellants' 2003 Form 540 NR and issued a Notice of Proposed  
13 Assessment (NPA) on December 3, 2007, which proposed to increase appellants' taxable income by  
14 \$749,786, the net gain from the sales of July 10 and October 14, for additional tax of \$67,844.  
15 Appellants protested the NPA and a protest hearing was held. Respondent affirmed the NPA in a Notice  
16 of Action (NOA) on November 19, 2008. Appellants filed this timely appeal. (Resp. Open. Br., p. 4.)  
17 Issue (1): Whether respondent properly determined that nonresident appellants were subject to income  
18 tax on gain from a sale of stock that occurred in California in a prior year when appellants were  
19 residents of California.

20 **Issue (1): Whether respondent properly determined that the subject sale of appellants' stock**  
21 **occurred in 2002 when appellants were residents of California and thus gain on the sale was**  
22 **taxable by California.**

23 Contentions

24 Appellants' Contentions

25 Appellants contend that the terms of the agreement between Avantec and Goodman  
26 provided that "the sale of unvested employee shares would occur after the shares vested" and "[b]efore  
27 all of their shares vested, [appellants] moved to Nevada and established Nevada residency." Thus,  
28 appellants contend that they reported all gain from "the shares that vested and were sold" while they

1 were California residents. (App. Open. Br., p. 2.)

2 Appellants argue that “the sale giving rise to such gain occurred after [they] had  
3 established their Nevada residence and the shares vested.” In support of their position, appellants  
4 contend that under California law, gain on the sale of intangible property such as stock is sourced to  
5 California if the seller is a California resident at the time of the sale. If the seller is not a resident, then  
6 the gain is sourced to California only if the intangible property has a business situs in California, which  
7 respondent concedes was not the case here. Furthermore, appellants contend that in a stock sale “it is  
8 settled that when the shares are transferred to an escrow account pursuant to an agreement to sell the  
9 shares . . . the sale takes place after all escrow conditions are satisfied and after the sale proceeds are  
10 distributed to the seller.” (App. Open. Br., p. 3 and p. 6.)

11 Appellants state that the LOI provides for the distribution of the sale proceeds when the  
12 following conditions are satisfied: (1) Avantec signs the agreement, (2) sellers deposit their shares in  
13 escrow, (3) the waiting period under the Hart-Scott-Rodino Act has lapsed or been terminated, and (4)  
14 “in the case of stock subject to repurchase and unvested shares, the purchase price shall be held in  
15 escrow as repurchase rights lapse or as the shares vest and are exercised, as the case may be.”

16 Appellants also assert that the LOI expressly stated the transfer of the shares to the escrow account was  
17 not intended to constitute a completed sale as evidenced by the following provision: “For avoidance of  
18 doubt, this escrow is simply to facilitate the delivery requirements pursuant to an exercise of the Share  
19 Option by Purchaser (and not to confer any rights in the stock to Purchaser or otherwise abrogate such  
20 Selling Shareholders’ ownership of, or rights, preferences or privileges in such stock, as applicable.”  
21 (App. Open. Br., p. 6.)

22 Appellants dispute respondent’s contention that the gain at issue is California-source  
23 income because the sale occurred in 2002 and those amounts were realized while appellants were  
24 California residents. Appellants assert that respondent’s position is that they sold their shares in 2002  
25 and they simply received installment payments in 2003. Appellants contend that respondent incorrectly  
26 reasons that “there was no longer any substantial risk of forfeiture for any unvested shares when the deal  
27 closed on July 30, 2002” and “the monies were fixed and realized at that time.” Appellants also point  
28 out that respondent claims the payment received in January 2003 is evidence “that all substantial

1 contingencies had been met at the time of sale” because that payment was for a pro rata portion of all the  
2 shares, vested and unvested, held in escrow. Appellants argue that respondent’s position ignores the fact  
3 that they could not sell unvested shares at any time and therefore were not entitled to distributions from  
4 the escrow account until the shares vested and the other conditions were satisfied. (App. Open. Br.,  
5 pp. 6-7.)

6 Appellants assert that pursuant to title 18 of the California Code of Regulations, section  
7 (Regulation) 19752, subdivision (d), the source of gains and losses from the sale of stock is determined  
8 at the time of the sale of the stock and the sales that resulted in the gain at issue here took place after  
9 they became Nevada residents. Appellants assert that when a sale of property is subject to the  
10 fulfillment of certain conditions while the property is in escrow, no sale occurs until those conditions are  
11 fulfilled. In support of their position, appellants cite *Dyke v. Comm’r* (1946) 6 T.C. 1134, in which a  
12 taxpayer prior to the sale of stock transferred his shares to an escrow account while the purchaser  
13 transferred the purchase price to the escrow account. The agreement provided that the shares and  
14 proceeds could not be distributed until certain conditions were satisfied. The Internal Revenue Service  
15 (IRS) argued that the sale occurred on the date that substantially all the conditions were fulfilled, except  
16 payment to the taxpayers. The court disagreed and held that the sale occurred when all conditions were  
17 fulfilled, i.e., upon delivery of the shares to the purchaser and payment to the taxpayer. (App. Open. Br.,  
18 pp. 7-8.)

19 Appellants argue that the two payments received on July 10, 2003, and October 14, 2003,  
20 were solely for the sale of shares that vested after they became Nevada residents. Thus, according to  
21 appellants, pursuant to the foregoing authorities the sale of the shares at issue occurred when the sale  
22 proceeds and shares were released from escrow, which did not occur until appellants were residents of  
23 Nevada. Moreover, appellants dispute respondent’s assertion that “all substantial contingencies had  
24 been met at the time of the sale” because their shares were still subject to Avantec’s repurchase rights.  
25 Appellants contend that the repurchase rights were a substantial contingency in that vesting of the shares  
26 provided them with the ownership rights required to complete the sale. (App. Open. Br., pp. 8-9.)

### 27 Respondent’s Contentions

28 Respondent contends that appellant sold the Avantec stock in 2002 when appellants were

1 California residents and received four payments resulting from that sale in 2003. Respondent then cites  
2 Regulation 19752, subdivision (d), which provides, in pertinent part, that for the sale of intangible  
3 property under the installment method by a California resident, “any later recognized gain attributable to  
4 any installment payment receipts relating to that sale will be sourced to California.” Because appellant  
5 was a California resident at the time of the sale, respondent contends that all gain from the payments  
6 made for the stock is sourced to California, regardless of appellants’ Nevada residency in the latter part  
7 of 2003. Respondent also contends that its determinations are presumptively correct and appellants have  
8 the burden of proving error. (Resp. Open. Br., p. 5.)

9 Respondent asserts that appellant’s characterization of the transaction, which respondent  
10 disputes, is “a series of mini-sales that occurred ‘when the sale proceeds and shares were released from  
11 escrow.’” Respondent contends that appellants’ characterization is repudiated by “the limited  
12 documentation” provided in this appeal and respondent notes that appellants have not provided the  
13 May 15, 2002, Purchase Agreement or any information or instructions related to the cash escrow  
14 account, the timing of the payments to appellants, and the calculation of the payment amounts.  
15 Respondent also states that appellants have not provided any documents dated after May 29, 2002,  
16 relating to the Goodman purchase of the Avantec stock. (Resp. Open. Br., p. 6.)

17 Respondent asserts that the LOI does not describe the transaction as a series of small  
18 sales over a two-year period and that the Memorandum states that the second stage of the transaction  
19 “involves Goodman potentially acquiring the remaining portion of the Company from its stockholders  
20 by no later than January 31, 2003.” As to the first stage of the transaction, respondent states that  
21 Goodman was required to deposit \$3.2 million just to acquire appellants’ 800,000 shares. After  
22 purchasing the option for \$4 per share, Goodman then had until January 31, 2003 to choose one of the  
23 three alternatives, from which Goodman chose the 100% Option to purchase all the remaining Avantec  
24 shares. Respondent states that Goodman then paid an additional \$4.8 million for appellant’s shares  
25 which respondent assumes would have been made no later than July 30, 2002, the date that Goodman  
26 completed its acquisition of Avantec. (Resp. Open. Br., pp. 6-7, exh. H, p.1.)

27 Respondent further argues that appellants have confused the requirements surrounding  
28 the \$4.00 option purchase price and the \$6.00 100% Option payment. With respect to the LOI,

1 respondent quotes appellants' statement that the LOI provides for the distribution of the sale proceeds  
2 when the following conditions are satisfied: (1) Avantec signs the agreement, (2) sellers deposit their  
3 shares in escrow, (3) the waiting period under the Hart-Scott-Rodino Act has lapsed or been terminated,  
4 and (4) "in the case of stock subject to repurchase and unvested shares, the purchase price shall be held  
5 in escrow as repurchase rights lapse or as the shares vest and are exercised, as the case may be."

6 Respondent contends that the language cited by appellants governs only the \$4.00 per share Option  
7 purchase price and not the \$6.00 per share 100% Option payment. Respondent asserts that its  
8 interpretation is supported by paragraph III of the LOI titled "Option Price" which provides for the  
9 \$4.00 per share Option price which shall be deposited to an escrow fund no later than May 15, 2002,  
10 with escrow instructions to "make payment of the Option Purchase Price to each of the Selling  
11 Shareholders immediately upon" the occurrence of stated events. The paragraph continues by stating  
12 "[t]he consideration to be paid for common stock subject to repurchase and unvested stock options shall  
13 be held in the escrow fund by the Company as repurchase rights lapse or as the share underlying such  
14 options vest and are exercised as the case may be." Respondent argues that the instructions explain that  
15 Goodman would deposit the \$4.00 per share Option Purchase Price in the cash escrow account, in return  
16 the sellers would deposit their shares into the escrow account and the sellers would receive payment of  
17 the \$4.00 per share. For appellants, with respect to the unvested shares, the \$4.00 per share Option  
18 Purchase Price would be held in escrow until the repurchase rights lapsed. (Resp. Open. Br., pp. 8-9.)

19 Respondent asserts that paragraph IV of the LOI reiterates that 100 percent of the Option  
20 Purchase Price would be paid to the selling shareholders per paragraph III. Paragraph IV further  
21 provides that, with respect to the \$6.00 per share 100% Option payment which "shall be paid to the  
22 Selling Shareholders at Closing" subject to a 5 percent "holdback" amount "held in escrow for two  
23 months following Closing pending determination of a purchase price adjustment, if any." Respondent  
24 argues that this language means that appellants would receive 95 percent of the \$6.00 per share 100%  
25 Option Payment at the closing of the sale to Goodman and the remaining 5 percent two months later.  
26 Respondent further argues that appellants have not addressed the difference in the timing of the payment  
27 of the \$4.00 per share Option Price and the timing of the \$6.00 per share 100% Option Payment. Thus,  
28 respondent concludes that those provisions defer only the release of the Option Purchase Price payments

1 but not the date of the sale of the shares to Goodman. (Resp. Open. Br., pp. 9-10.)

2 Respondent also disagrees with appellants' citation of language from the LOI that  
3 appellants contend "expressly stated that the transfer of the shares to the escrow account was not  
4 intended to constitute a completed sale". Respondents state that language related to the exercise of the  
5 "Share Option" is irrelevant to this discussion because Goodman exercised the 100% Option. Finally,  
6 respondent asserts that its position that the sale occurred in 2002 is supported by the consent forms  
7 appellants signed to the May 15, 2002 Purchase Agreement between Goodman, Avantec and the Sellers.  
8 According to the consent forms, respondent notes, appellants confirmed their agreement to be "bound"  
9 by the provisions of the Purchase Agreement and by "any obligation to purchase and sell" their shares  
10 and "to take all such action as may be necessary to facilitate the sale of such equity interests of the  
11 Company." Respondent also quotes language from the Memorandum stating that the "holders of more  
12 than 90% of the outstanding stock of Avantec . . . have already entered into an agreement to sell their  
13 shares to Goodman" and encouraging other shareholders "to join us in effecting this transaction."  
14 (Resp. Open. Br., p. 10.)

15 Respondent contends that the cases cited by appellants to support their position that a sale  
16 occurs after escrow conditions are fulfilled are distinguishable from the facts of this appeal. In *Dyke v.*  
17 *Comm'r, supra*, respondent states, that the sellers, including the taxpayer, signed an agreement to sell  
18 shares of a stock in a transportation company to another transportation company. The parties were  
19 required to obtain the permission of the Interstate Commerce Commission (ICC) before the sale could  
20 be completed. The taxpayer deposited his shares in an escrow account on April 1, 1941 and the ICC  
21 gave its permission on July 31, 1941. The buyer granted the sellers' request for an extension of the  
22 delivery date to September 10, 1941 in order to close its books. The conditions of the escrow agreement  
23 were fulfilled as of September 10, 1941, and the buyer paid for and received the shares from the escrow  
24 account. In its decision, the tax court held that the buyer "had no legal obligation to pay the purchase  
25 price . . . until all of the conditions of escrow agreement had been complied with." (Resp. Open. Br.,  
26 p. 12.)

27 Respondent contends that appellant entered into a binding contract to sell his shares to  
28 Goodman as part of Goodman's acquisition of Avantec in 2002. Pursuant to the contract, appellant

1 deposited his shares in the escrow account, but unlike *Dyke, supra*, Goodman was contractually required  
2 to pay the \$6.00 per share 100% Option Payment “within 15 days after the indication.” Respondent  
3 asserts that Goodman made its indication sometime between May 29, 2002, and July 30, 2002, and was,  
4 therefore, required to pay the 100% Option Payment in 2002. Moreover, respondent believes that  
5 Goodman deposited the purchase price in the escrow account not later than July 30, 2002, the date  
6 Goodman completed its acquisition of Avantec. Thus, respondent asserts that the sale of the stock was  
7 completed in July 2002, and not in 2003. (Resp. Open. Br., p. 12.)

8 With respect to *Gray v. Comm’r* (9th Cir.1977) 561 F.2d 753, 757, respondent states that  
9 in that case the stock was “placed in escrow, subject to the condition that the ‘sale’ would be undone if  
10 the redemption did not occur.” By contrast, respondent states that the documentation provided does not  
11 describe what would happen to the shares or the cash in the escrow account in the event the transaction  
12 was not completed. Respondent argues that once Goodman exercised the 100% Option, Goodman was  
13 obligated to purchase all the outstanding Avantec shares and did so. Thus, there were no outstanding  
14 conditions that would undo the sale. (Resp. Open. Br., p. 13.)

15 Respondent takes issue with appellants’ claim that the sales occurred in 2003 as the  
16 underlying shares vested, and argues that the timing and amounts of the payments appear unrelated to  
17 the vesting of the shares. Respondent points out that appellant received quarterly payments in 2003  
18 whereas appellant’s shares, pursuant to his agreement with Avantec, vested monthly through  
19 November 5, 2003. In order for appellants’ claim to be valid, respondent argues, the sales would have  
20 occurred each month as the shares vested, and not when the payments were made. For the sake of  
21 consistency, respondent asserts that appellants should have reported as California income the payment  
22 for the shares that vested on May 5, 2003, when appellants were still California residents. Moreover,  
23 respondent notes that the final payment of \$375,000 was received on October 5, 2003,<sup>4</sup> whereas the last  
24 shares did not vest until one month later on November 5, 2003. Additionally, respondent states that  
25 appellants received a total of \$1.5 million in payments in 2003 allegedly for the 183,333 remaining  
26 unvested shares as of January 1, 2003, which reflects a price of \$8.18 per share rather than the \$10.00  
27

28 <sup>4</sup> Respondent states that the receipt date was October 5, 2003, but other documentation in the record, including Form 1099-  
OID shows a sale date of October 14, 2003. (Resp. Open. Br., exh. K, p.1.)

1 per share as stated in the agreement. Thus, there appears to be no relationship between the 2003  
2 payments and the vesting of the shares. Finally, respondent argues that Goodman publicly  
3 acknowledged in a press release that the acquisition of Avantec was completed as of July 30, 2002.  
4 (Resp. Open. Br., pp. 13-14.)

5 With respect to the substantial contingency issue, respondent states that it could find no  
6 language in the Agreement or the Addendum to support appellants' claim that appellant was required to  
7 continue working for Avantec in order for his shares to continue vesting. Respondent also states that it  
8 could not find any forfeiture language in the documents. Respondent asserts that the only restriction on  
9 appellant's unvested stock was an option for Avantec to repurchase the stock, if appellant ended his  
10 employment with Avantec. If Avantec did not exercise the option within 90 days of appellant's  
11 employment ending, the option would lapse and in the absence of any other provision, appellant would  
12 continue to hold the shares until they vested. In view of the foregoing, respondent concludes that it does  
13 not appear that Avantec's repurchase option was a substantial contingency. (Resp. Open. Br., pp. 14-15.)

14 Respondent further argues that Avantec's right to repurchase "appears eviscerated" by  
15 the sales agreement between Goodman, Avantec and the Selling Shareholders. Although none of the  
16 documents provided discuss the effect of Goodman's acquisition on Avantec's right to repurchase,  
17 respondent surmises Goodman would have been required to cancel its acquisition agreement if it wanted  
18 to exercise the right to repurchase appellant's unvested shares which seems to be an absurd result. Thus,  
19 according to respondent, Goodman's acquisition removed even the possibility that Avantec's right to  
20 repurchase constituted a substantial contingency. (Resp. Open. Br., pp. 15-16.)

#### 21 Appellants' Reply Brief

22 Appellants contend that there was not a completed sale for the unvested shares in 2002  
23 because the payment for those unvested shares was placed in the escrow account but appellants were not  
24 entitled to receive those payments until the shares vested in 2003. Appellants point to the case law, cited  
25 above, for the proposition that a sale for tax purposes takes place at the point at which the burdens and  
26 benefits of ownership are transferred and that no sale occurs until all escrow conditions are met. As in  
27 those cases, appellants contend, there was no legal obligation to pay the purchase price until all  
28 conditions of the escrow agreement were satisfied. That is, appellant had no right to demand the sale

1 proceeds for the unvested shares until they vested, which is confirmed by the fact that the proceeds were  
2 not released until that time. (App. Reply Br., p.3.)

3 Appellants contend that the premise of respondent's position is that Goodman would  
4 have been willing to pay appellants for unvested shares in 2002. Appellants contend that it is illogical to  
5 presume that Goodman would have paid them \$10.00 per share without any conditions when those  
6 shares were subject to a right to repurchase. Specifically, appellants argue that if appellant terminated  
7 his employment prior to all the shares vesting, then Goodman, as Avantec's assignee, could have  
8 repurchased the unvested shares for \$0.001 per share. Thus, it would not have made economic sense for  
9 Goodman to pay \$10.00 per share in 2002. (App. Reply Br., p.3.)

10 Appellants further contend that Regulation 17952, subdivision (d) provide only that the  
11 source of gains and losses are determined at the time of a sale of property, but does not address the issue  
12 here which is when the sale actually took place. Appellants also argue that, contrary to respondent's  
13 suggestion, "the payment for the unvested shares correlated closely to the number of unvested shares."  
14 Appellants add that the payments were made quarterly, rather than on a monthly basis, for  
15 administrative ease. (App. Reply Br., p. 4.)

16 With respect to respondent's position that there was no provision that required appellant  
17 to continue his employment with Avantec in order for his shares to continue vesting, appellants argue  
18 that "the contingency is that the unvested shares are expressly subject to a right of repurchase upon  
19 termination of [his] employment." Appellants further argue that "the contingency is the vesting of the  
20 shares and the lapse of the repurchase option." Appellants conclude that, under *Gray* and *Dyke*, those  
21 conditions are substantial contingencies. Finally, appellants argue that respondent's assumption that the  
22 repurchase option was revoked by the stock sale agreement is unfounded because Avantec continued as  
23 a separate corporation and agreements between Avantec and appellant remained in effect. (App. Reply  
24 Br., pp. 4-5.)

#### 25 Applicable Law

26 R&TC section 17041 provides that the California taxable income of a California  
27 nonresident includes gross income and deductions derived from California sources. R&TC section  
28 17951 provides that for nonresident taxpayers, gross income includes only the gross income from

1 sources within California. Regulation 17951-1, subdivision (a) provides that nonresidents are taxable  
2 only upon taxable income derived from sources within this state as defined in Regulation 17951-2.  
3 Regulation 17951-2 provides that “[i]ncome from sources within this State includes . . . income from  
4 stocks, bonds, notes, bank deposits and other intangible personal property having a business or taxable  
5 situs in this State. . .”

6 IRC section 83(a) provides, in relevant part, if property is transferred to a taxpayer in  
7 connection with the taxpayer’s performance of services:

8 “the excess of (1) the fair market value of such property (determined without regard to  
9 any restriction other than a restriction which by its terms will never lapse) at the first time  
10 the rights of the person having the beneficial interest in such property are transferable or  
11 are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the  
12 amount (if any) paid for such property, shall be included in the gross income of the  
13 person who performed such services in the first taxable year in which the rights of the  
14 person having the beneficial interest in such property are transferable or are not subject to  
15 a substantial risk of forfeiture, whichever is applicable.”

16 However, under IRC section 83(b), the taxpayer may elect to include in his gross income, for the taxable  
17 year in which such property is transferred, “the excess of (A) the fair market value of such property at  
18 the time of transfer (determined without regard to any restriction other than a restriction which by its  
19 terms will never lapse), over (B) the amount (if any) paid for such property.” Thus, IRC section 83(b)  
20 effectively allows the taxpayer to elect to report the difference between: 1) the fair market value of the  
21 stock (disregarding any restrictions except those that will not lapse) and 2) any consideration paid by the  
22 taxpayer. As a result of reporting the taxable income in the year the stock is transferred, the taxpayer’s  
23 subsequent sale of the stock will be subject to capital gains treatment.

24 There are no hard and fast rules of thumb that can be used in determining, for taxation  
25 purposes, when a sale was consummated, and no single factor is controlling; the  
26 transaction must be viewed as a whole and in the light of realism and practicality.  
27 Passage of title is perhaps the most conclusive circumstance. A factor often considered is  
28 whether there has been such substantial performance of conditions precedent as imposes  
upon the purchaser an unconditional duty to pay.

(*Commissioner v. Segall* (6th Cir. 1940) 114 F.2d 706, 709-710 [citations omitted].)

*Dyke, supra* involved the sale of shares of stock that were placed in escrow pending the  
fulfillment of stated conditions and the purchaser had no legal obligation to pay the purchase price until  
all of the conditions of the escrow agreement had been complied with. One of the terms of the escrow

1 agreement was that the shares of stock should be held by the escrow agent until it received payment for  
2 the shares. Based on the terms of the escrow agreement, the tax court held that it was the intention of  
3 the parties that the sale was not to be consummated until the delivery date when the purchase price was  
4 paid.

5 In *Gray, supra*, the taxpayer sought to sell his shares in Company A which held 15,000  
6 preferred shares of Company B. The taxpayer and the purchaser entered into an agreement whereby the  
7 purchaser would buy the taxpayer's Company A shares, subject to a condition subsequent negating the  
8 transaction if the Company B preferred shares were not redeemed within six days after the sale of the  
9 Company A shares. To ensure that Company B would be able to redeem the preferred shares, the  
10 taxpayer arranged for Company B's subsidiary to lend approximately \$1.3 million to Company B four  
11 days prior to the planned sale. The court found that completion of the transaction was subject to real  
12 contingencies because the taxpayer was not free to demand the sale proceeds until the redemption  
13 occurred. Thus, the court held that the sale of the Company A shares occurred after the redemption of  
14 the Company B preferred shares.

#### 15 STAFF COMMENTS

16 According to the facts presented, Avantec and the Selling Shareholders established an  
17 escrow account and deposited all Avantec shares, including the unvested shares held by Avantec  
18 employees. Goodman established an escrow account and transferred the entire purchase price for all the  
19 Avantec shares, including the amount to be paid for the unvested shares. Paragraph IV of the LOI states  
20 that the \$6.00 per share 100% Option Payment "shall be paid to the Selling Shareholders at Closing"  
21 (subject to a 5% holdback amount for a two-month period). According to paragraph II of the LOI,  
22 "Closing" is described as the consummation of the Transaction that shall take place as soon as possible  
23 after the May 15, 2002, signing of the Definitive Agreement but not later than January 31, 2003. Thus,  
24 it appears the LOI indicates that the parties intended that payment of the purchase price would occur by  
25 January 31, 2003, and there is no express language in the LOI indicating that the transfer of the purchase  
26 price was subject to a condition subsequent such as the vesting of the Selling Shareholders' shares.

27 At the hearing, appellants should be prepared to explain how the evidence in the record  
28 supports their assertion that the shares were subject to a condition subsequent. In this regard, appellants

1 should be prepared to discuss the terms set forth in the Definitive Agreement. Based on that  
2 information, the parties should be prepared to explain the consequences for the transaction with respect  
3 to the sale of appellants' unvested shares if appellant's employment had terminated before all of his  
4 shares vested.

5 **Issue (2): If respondent properly determined that the gain in issue is California-source income,**  
6 **whether appellants were taxable on that gain in 2002 so that respondent should have issued a**  
7 **proposed assessment of additional tax for 2002, rather than 2003.**

8 Contentions

9 Appellants' Contentions

10 Appellants contend that, even if one accepts respondent's position that the sale occurred  
11 when the agreement was executed in 2002, respondent's action must be reversed because it assesses  
12 additional tax for tax year 2003. Appellants further contend that respondent may not correct its mistake  
13 by making an additional tax assessment at this time because the limitations period for issuing a NPA for  
14 2002 has expired. (App. Open. Br., p.3 and p.9.)

15 In their reply brief, appellants repeat their contention that, assuming that respondent's  
16 position is correct that the sale occurred in 2002, the income was taxable in 2002, not 2003. For  
17 support, appellants cite case law for the proposition that a purchaser's deposit of funds into an escrow  
18 account results in constructive receipt of those funds by the seller. Hence, according to respondent's  
19 characterization of the transaction, appellants contend that they constructively received the total  
20 payment in 2002, and the use of the installment method is not available. (App. Reply Br., p.6.)

21 Respondent's Contentions

22 With respect to appellants' alternative argument that, based on respondent's position, the  
23 NPA should have been issued for 2002, respondent asserts that appellants' argument confuses the  
24 sourcing of the income resulting from the sale in 2002 with the recognition of the income in 2003.  
25 Respondent asserts that pursuant to Regulation 17952, subdivision (d), the source of the income is  
26 determined at the time of the sale. However, because appellants are cash method taxpayers and received  
27 the payments at issue in 2003, those amounts were recognized in that year and are includable in their  
28 2003 taxable income. Appellants' alternative argument would have required respondent to issue an

1 NPA for amounts appellants had not yet received. (Resp. Open. Br., p. 16.)

2 Applicable Law

3 Regulation 17952, subdivision (d) provides in relevant part that:

4 “the source of gains and losses from the sale or other disposition of intangible personal  
5 property is determined at the time of the sale or disposition of that property. For example,  
6 if a California resident sells intangible personal property under the installment method,  
7 and subsequently becomes a nonresident, any later recognized gain attributable to any  
8 installment payment receipts relating to that sale will be sourced to California (absent a  
9 business situs exception).”

10 IRC section 451(a), which is incorporated by R&TC section 17551, generally provides  
11 that:

12 “any item of gross income shall be included in the gross income for the taxable year in  
13 which received by the taxpayer, unless, under the method of accounting used in  
14 computing taxable income, such amount is to be properly accounted for as of a different  
15 period.”

16 In *Oden v. Comm’r* (1971) 56 T.C. 569, which is cited by appellants, the taxpayers sold  
17 property to the purchaser who paid cash on the closing date and executed promissory notes payable in  
18 five consecutive annual installments. The parties executed purported agreements which provided that  
19 these notes were secured by certificates of deposit, each certificate having a principal amount and  
20 maturity date corresponding to the principal amount and maturity date of each installment of the notes.  
21 The certificates were endorsed in blank and deposited in escrow. (Id. at pp. 573-574.)

22 The taxpayers elected to report the transaction as an installment sale but the court  
23 disagreed finding that the purchaser did not remain obligated on the promissory notes. Instead, the  
24 purchaser’s obligation was satisfied at the time he purchased the certificates of deposit and endorsed  
25 them in blank and, thus, the taxpayers had a right to the certificates of deposit which had value on the  
26 date of sale. (Id. at p. 574.) As support for its conclusion, the court noted that the taxpayers’ rights to  
27 the principal amount of the certificates of deposit were “not restricted in any meaningful way by  
28 the escrow arrangement” because the escrow was mutually agreed upon by the taxpayers and purchaser  
and it was the taxpayers who insisted that the purchaser acquire the certificates. Thus, the court  
concluded that the certificates of deposit were available to the taxpayers in the year of the sale, but the  
taxpayers agreed to defer receipt to later years. Under those circumstances, the court held that the

1 taxpayers received the right to the principal amount of the certificates in the year of the sale. (Id. at p.  
2 577.)

3 In *Stiles v. Comm’r* (1978) 69 T.C. 558, also cited by appellants, the taxpayer, who  
4 reported on the cash basis, elected to report the gain from the redemption of his corporate stock on the  
5 installment method. The taxpayer received 25 percent of the redemption price in cash and, at the  
6 redeeming corporations’ option, the remaining 75 percent was placed into a trust for the taxpayer’s  
7 benefit. The trust funds were payable to petitioner over several years and were to secure the redeeming  
8 corporations against any reasonably anticipated breaches of certain warranties and representations made  
9 by the taxpayer. The court held that the trust funds were subject to substantial restrictions and, thus, the  
10 taxpayer did not constructively receive the trust funds or receive the economic benefit thereof in the year  
11 of sale. Consequently, the court held that the taxpayer properly elected the installment method of  
12 accounting.

13 STAFF COMMENTS

14 As indicated above, from the terms of the LOI it seems that the parties intended total  
15 payment of the purchase price at Closing, i.e., no later than January 31, 2003, but distribution of portions  
16 of that total purchase price from the escrow account to the Selling Shareholders as their shares vested.  
17 Thus, it appears that appellants’ right to receipt of those distributions, unlike the taxpayer in *Oden*,  
18 *supra*, was “restricted in a meaningful way by the escrow arrangement”. At the hearing, appellants  
19 should be prepared to point to any language in the Definitive Agreement or any documentation  
20 indicating that each distribution made to appellants constituted a separate stock sale transaction.

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