

1 John O. Johnson
2 Tax Counsel
3 Board of Equalization, Appeals Division
4 450 N Street, MIC: 85
5 PO Box 942879
6 Sacramento, CA 95814
7 Tel: (916) 323-3140
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 **KEVIN H. SULLIVAN AND**) Case No. 610943
13 **CLAIRE K. SULLIVAN¹**)

		Proposed
	<u>Years</u>	<u>Assessments²</u>
	2007	\$ 3,930
	2008	\$444,304

18 Representing the Parties:

19 For Appellants: Arthur A. Oshiro, Esq.
20 For Franchise Tax Board: Maria Brosterhous, Tax Counsel

22 **QUESTION:** Whether appellants have shown error in respondent's calculation of their
23 California-sourced income and the resulting proposed assessments for 2007 and 2008.

25 ¹ Appellants reside in Incline Village, Nevada.

26 ² Respondent modifies the proposed assessments on appeal based on concessions regarding the number of workdays that
27 appellant-husband was in California during the time period at issue, as discussed further herein. As a result, respondent
28 states that it will reduce the proposed assessment for 2007 from \$3,930 to \$2,632 and the proposed assessment for 2008
from \$444,304 to \$380,050. Respondent issued a second proposed assessment in the amount of \$164 for 2007 based on
federal adjustments. Respondent states, on appeal, that it will withdraw this assessment. (Resp. Op. Br., p. 7, fn. 8.)

Appeal of Kevin H. Sullivan
And Claire K. Sullivan

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

1 HEARING SUMMARY

2 Background

3 Factual Background

4 Appellant-husband³ worked as a Western Regional Manager of Lumber Liquidator,
5 Inc., (LLI) from 1997 through the end of 2008, and performed services both within and without
6 California. On August 1, 2005, appellant-husband renewed his employment agreement to continue to
7 serve as the Western Regional Manager for LLI and also entered into a Stock Option Agreement.
8 Appellant-husband's brother, Thomas Sullivan, who was the Chairman of the Board of LLI during the
9 years at issue, was also a party to the Stock Option Agreement (SOA). The SOA stated that
10 appellant-husband was entitled to shares of common stock in LLI in recognition for "services
11 previously provided to [LLI] during seven years of continuous employment."⁴ (Resp. Op. Br.,
12 exhibit A, p. 1.) In addition to services previously rendered, the purchase price for the stock was set at
13 a total price of one dollar. The number of shares included in the SOA was comprised of shares equal
14 to two and one-half percent of the total common stock of LLI plus a number of common stock shares
15 with an aggregate value equal to ten and one-half percent of the value of the Western Region of LLI,
16 to be calculated at the time the option becomes fully exercisable. The SOA stated that the option
17 would become fully exercisable immediately prior to the completion of an Initial Public Offering
18 (IPO) or a Sale Event, upon certain other events such as a breach of the agreement by LLI or wrongful
19 termination, and in any case no later than February 1, 2008. (*Id.* at pp. 2-3.) Appellant-husband's
20 brother was required under the SOA to place 1.5 million shares of common stock into an escrow
21 account. (*Id.* at pp. 7-8.)

22 Subsequently, on December 30, 2006, the SOA was amended to conform to the

23 ///

24 ///

25 _____
26 ³ In various documents provided by the parties, appellant-husband is referred to by his full name, Kevin H. Sullivan, his
27 initials, KHS, and also "Sam Sullivan."

28 ⁴ Although specific dates are not provided for the seven years of service, it appears the seven years is intended to include
time of service between 1997 and no later than the date of the agreement on August 1, 2005. We note that the total range of
this time is more than seven years of employment.

1 requirements of Internal Revenue Code (IRC) section 409A⁵ by stating that the option would vest upon
2 the earlier of appellant-husband's death, permanent disability, an IPO, change in control of LLI,
3 termination without cause, material breach of the agreement, or on February 1, 2008. (Resp. Op. Br.,
4 exhibit B.) LLI completed an IPO on November 9, 2007. (See *Id.* at exhibit C.) The amendment
5 became the subject of arbitration proceedings between the three parties to the SOA on
6 November 30, 2007, over multiple issues including the timeliness of appellant-husband's exercise of the
7 option and the calculation of the number of shares. (*Id.* at p. 3.) On February 1, 2008, during the
8 arbitration proceeding, appellant-husband issued a letter and that payment of the required one dollar
9 purchase price to exercise his option. The arbitrator issued a decision on December 1, 2008,
10 determining that the option vested on November 9, 2007, and was timely exercised with the
11 February 1, 2008 letter. The arbitrator also determined that LLI properly calculated the number of
12 shares using the IPO as both the date in which the option vested and became exercisable.⁶ (*Id.* at
13 exhibit C.)

14 Appellants filed nonresident returns for 2007 and 2008 (Form 540NRs). (Resp. Op. Br.,
15 exhibits D and E.) Appellants reported federal wages of \$252,038 for 2007 and federal wages of
16 \$7,835,920 for 2008, and provided Forms W-2 from LLI confirming these amounts. An LLI earnings
17 statement for appellant-husband indicates that \$7,599,292⁷ of the 2008 income was from the exercise of
18 the stock options, which equals the fair market value of the stock over the price of the option.

19
20 ⁵ IRC section 409A became effective January 1, 2005, the year the SOA was created. The amendment specifies that it is
21 intended to make the SOA comply with regulations that were proposed for IRC section 409A. The effect of violating the
22 terms of this statute is to cause the intended deferred gain to become taxable immediately plus a 20 percent penalty.

23 ⁶ The SOA and the amendment provided that appellant-husband was required to pay in cash to LLI any required tax
24 withholdings when he exercised his option. If appellant-husband did not make such payment, then his brother would have
25 the right to call the option with respect to the number of shares having a value equal to the required tax withholdings and
26 make a cash payment to LLI as payment of the required tax withholdings. The value of the required tax withholding upon
27 exercising the option was \$3,030,627.20, which was calculated as 767,456 of appellant-husband's 853,853 shares under the
28 option, and Tom Sullivan called that amount to satisfy the required tax withholding. The arbitrator found that the above
actions were proper, except that the calculation of the value of the shares was improper, and found that the proper amount of
shares required to satisfy the \$3,030,627.20 required tax withholding was 324,826, leaving appellant-husband with 529,027
shares (i.e., 853,853 less 324,826). (Resp. Op. Br., exhibit C, pp. 14-16.)

⁷ Respondent appears to have mistyped the amount of taxable income on page 4 of its opening brief as \$7,499,292. All other
references report the amount as \$7,599,292. (See, e.g., Resp. Op. Br., p. 6; Appeal Letter, p. 2; App. Reply Br., exhibit 1,
p. 19.) The parties should clarify whether the portion of the taxable income for 2008 attributable to the stock option income
is an amount other than \$7,599,292.

1 Appellants did not report any California taxable income on the Schedule CA. (*Id.* at p. 4 and exhibit E,
2 p. 4.) Respondent began its examination of appellants' 2007 and 2008 tax returns in March of 2009, and
3 appellants provided copies of the SOA, the arbitration decision, the work day calendars recreated by
4 appellant-husband at the time of the audit, and the contemporaneous travel documents.

5 When determining work days in and out of California for the relevant periods at issue,
6 respondent (1) relied on the contemporaneous travel documents, rather the recreated work day calendar,
7 and (2) allocated unaccounted for work days to appellants' state of residence with the date of residence
8 change from California to Nevada being January 1, 2007.⁸ (Resp. Op. Br., p. 4.) For the stock option
9 income, respondent calculated appellant-husband's workdays in California for the period from August
10 of 2005, the date of the SOA, through February of 2008, the date the option was exercised, as being 314
11 out of 601 total workdays, or 52.25 percent of the days in that period. Therefore, respondent asserts that
12 52.25 percent of the \$7,599,292 in stock option income, i.e., \$3,970,630, is California-sourced. (Resp.
13 Reply Br., pp. 2-3.) Respondent treated appellants as nonresidents beginning January 1, 2007, and
14 determined that appellant-husband had 69 workdays in California out of 240 total workdays in 2007, for
15 a percentage of 28.75. Therefore, respondent asserts that 28.75 percent of appellant-husband's \$252,038
16 in salary income for 2007, i.e., \$72,461, is California-sourced. (*Id.* at pp. 3-4.) For appellant-husband's
17 salary and bonus income for 2008, respondent calculated appellant-husband's California work days in
18 2008 as 65 out of 230 total workdays, for a percentage of 28.26 percent. Therefore, respondent asserts
19 that 28.26 percent of appellant-husband's \$183,750 in salary income for 2008, i.e., \$51,928, and that the
20 same percentage of appellant-husband's \$61,782 in bonus income for 2008, i.e., \$17,460, is
21 California-sourced. (*Ibid.*)

22 Respondent issued Notices of Proposed Assessment (NPAs) for 2007 and 2008 on
23 November 23, 2010.⁹ (Resp. Op. Br., exhibit F.) Appellants protested the assessment by letter, and
24

25 ⁸ Respondent originally attributed more days to California, apparently including all unaccounted for work days up to
26 April 1, 2007, but alters this determination in its opening brief, and then further reduces the percentage of California
27 workdays in its reply brief to the total shown above.

28 ⁹ As noted herein and, as discussed in Staff Comments, respondent made concessions on appeal and modified the proposed
assessments. A third proposed assessment was also issued and affirmed for 2007 in the amount of \$164. (Appeal Letter,
exhibit 3.) This assessment has been conceded by respondent in its entirety, as discussed in Staff Comments. (See Resp. Op.
Br., p. 7, fn. 8.)

1 respondent affirmed the NPAs by issuing Notices of Action on April 26, 2012. This appeal followed.

2 Nonqualified Stock Option Overview

3 An Overview of Nonqualified Stock Options (NQSOs).¹⁰ The offering of nonqualified
4 stock options by corporations to their employees is a way for companies to compensate employees
5 without paying cash: corporations grant employees an option to purchase shares of stock in the
6 corporation in the future at a fixed price. The incentive to an employee to participate in such a program
7 is the potential increase in the employer's stock value. Since the granting of such options is a form of
8 compensation, an employee must generally report ordinary income when options are exercised. The
9 amount of ordinary income recognized is the difference between the option price (i.e., the amount paid
10 by the employee for the shares) and the fair market value of the shares on the date of purchase (i.e., the
11 exercise date).

12 NQSOs are typically awarded pursuant to a stock option plan which specifies that options
13 are subject to a vesting schedule. The vesting of options is also typically conditioned upon an
14 individual's continued employment with their employer and shares that are unvested as a result of an
15 employee's termination are subject to forfeiture.

16 Finally, no income is realized or recognized by an employee on either the grant or the
17 vesting of a NQSO. As mentioned above, income is only realized upon the exercise of a NQSO and
18 such income is compensation income to the employee. Here, the determination to be made is whether
19 some portion of appellant-husband's compensation income, from the exercise of the NQSOs, should be
20 treated as California source income.

21 Contentions

22 Appellants' Contentions

23 Appellants contend that the stock option grant date was November 9, 2007, not
24 August 1, 2005, and since he was no longer a California resident at the time the stock option was
25 granted and exercised, then no portion of his stock option income is subject to California income tax.
26 (Appeal Letter, p. 2.) Appellants cite to example 1 from the FTB's Residency & Sourcing Technical
27

28 ¹⁰ These options are also referred to as "nonstatutory stock options." Legal citations and additional analysis are provided in the Applicable Law section below.

1 Manual, under section 3520, titled Nonstatutory Stock Options, to emphasize the importance of
2 appellant-husband's state of residency at the time of the grant and exercise. Appellants assert that the
3 amendment to the SOA made clear that the parties intended the SOA to comply with IRC section 409A,
4 and cite the "date of grant of option" as "... the date when the granting corporation completes the
5 corporate action necessary to create the legally binding right constituting the option," and that the
6 corporate action "... is not considered complete until the date on which the maximum number of shares
7 that can be purchased under the option ... is designated." (Treas. Reg. § 1.409A-1(b)(5)(vi)(B).)
8 Appellants assert that the nature of the terms in the SOA provided that the number of shares that could
9 be acquired could not be determined until November 9, 2007, and the definite number of shares that
10 appellant-husband would receive could not be determined as of August 1, 2005. (*Id.* at pp. 4-8.)

11 Appellants assert that, if any portion of the stock option income is taxable in California,
12 it should be based on total California workdays over total workdays from the grant date to the exercise
13 date. (Appeal Letter, at p. 3.) Appellants contend that respondent's proposed calculation of workdays
14 in California and total workdays during the years at issue, as used for calculating the proposed
15 assessment is incorrect. Appellants contend on appeal (1) that all unaccounted for workdays after
16 January 1, 2007, should be attributed to their residence of Nevada, (2) that respondent incorrectly
17 omitted the months of July, 2007, and April, 2008, (3) that respondent overstated California workdays
18 by a total of 4 days in various months, and (4) that respondent misreported the California taxable
19 income in its reply brief based on its own calculations.¹¹ (App. Reply Br., pp. 1-4; App. Supp. Br.)

20 In their reply brief, appellants elaborate on the importance of the grant date when
21 calculating California taxable income for the stock option income. Appellants assert that
22 appellant-husband's attorney did not receive the final and executed SOA and related documents until
23 February 22, 2006, and that negotiations continued through October of 2005 and concluded in
24 mid-December of 2005. (App. Reply Br., p. 5 and exhibit 3.) Appellants contend that, if the Board
25 accepts respondent's allocation method, then the earliest date that should be used as the date the SOA
26

27 ¹¹ Respondent thereafter adjusted and presumably corrected its asserted workday calculations and resulting taxable income
28 amount, as discussed in Staff Comments below. By way of these adjustments, respondent has conceded to each of these four
contentions made by appellants.

1 was signed should be sometime in mid-December of 2005, and not August 1, 2005. (*Ibid.*) However,
2 appellants still assert that the vesting date of November 9, 2007, should be used as the starting date,
3 since that is the date when the maximum amount of stock that could be purchased under the SOA was
4 determinable in accordance with IRC section 409A and the aforementioned Treasury Regulation.¹²
5 Appellants contend that respondent's assertion that the August 1, 2005 date listed on the SOA is the
6 grant date frustrates the goal of IRC section 409A, lacks any legal basis, and should be rejected. (*Id.* at
7 pp. 6-8.)

8 Respondent's Contentions

9 Respondent asserts that nonresidents are taxed on income derived from a California
10 source, which can be determined by examining the location in which services are performed without
11 regard to the taxpayer's state of residency. (Resp. Op. Br., pp. 7-8; citing Rev. & Tax. Code, § 17041,
12 subds. (b) and (i); *Appeal of Robert C. Thomas and Marian Thomas*, 55-SBE-006, April 20, 1955;
13 *Appeal of Charles W. and Mary D. Perelle*, 58-SBE-057, Dec. 17, 1958; *Appeal of Janice Rule*,
14 76-SBE-099, Oct. 6, 1976; *Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.)
15 Respondent asserts that the location where the services are performed determines the source of the
16 option income, not appellant-husband's state of residence as of the date of exercise. (Citing *Appeal of*
17 *Perelle, supra.*) Therefore, respondent bases its calculation of California taxable income for the stock
18 option income, annual salaries, and bonus income on workdays in California over total workdays.

19 Respondent cites Regulation section 17951-5, subdivision (b), which provides that, for
20 employees paid on "some other basis," that "the total compensation for personal services must be
21 apportioned between this State and other States . . . in such a manner as to allocate to California that
22 portion of the total compensation which is reasonably attributable to personal services performed in this
23 State." (Cal. Code Regs., tit. 18, § 17951-5, subd. (b).) Respondent asserts that it applied a reasonable
24 method of allocation by using a ratio of California workdays over total workdays for the period of
25 service. For annual salaries and the 2008 bonus, the period of service is the respective calendar year.
26

27
28 ¹² Appellants provide various examples of subsequent events to show that the precise number of shares that
appellant-husband would be entitled to under the SOA could not be known as of August 1, 2005, including not knowing if or
when an IPO would occur, that subsequent dilution of shares by the granting of stock options to other key executives, and the
fluctuating value of the company. (Appeal Letter, pp. 5-8.)

1 For the stock option income, respondent asserts that the relevant period is from the grant date to the
2 exercise date. (Resp. Op. Br., pp. 10-13.) Respondent based its calculation of workdays in California
3 and total workdays on appellant-husband's contemporaneous travel documents from the periods at issue,
4 with adjustments made on appeal based on appellants' contentions.¹³

5 Respondent asserts that the option was granted by the SOA on August 1, 2005.
6 Respondent contends that the SOA explicitly states that through the agreement appellant-husband was
7 receiving a "grant of option" awarding him "the right and option to purchase" shares, and indicates that
8 the Arbitration Award defines the date of the IPO, November 9, 2007, as the date of *vest*, not as the date
9 of grant. (Resp. Op. Br., p. 9 and exhibit C, pp. 11-12.) Respondent asserts that using a vest to exercise
10 period is problematic because it does not bear a clear relation to the actual time for which the option was
11 offered as compensation, does not accurately reflect the location of where the service was performed,
12 and is inconsistent with the principles for taxing gain on the exercises of NQSOs as compensation.¹⁴
13 (*Id.* at p. 12.)

14 Respondent argues that IRC section 83(a) is the controlling statute for determining the
15 date of grant, not IRC section 409A. Respondent contends that IRC section 409A sets forth the rules for
16 determining when a nonqualified deferred compensation plan fails and the resulting penalties, whereas
17 IRC section 83(a) sets forth the taxation of NQSOs. Furthermore, respondent asserts that its
18 determination of the grant date is not contrary to IRC section 409A, and restates that IRC section 409A
19 does not control here because there has not been a plan failure of any kind. (Resp. Reply Br., p. 5.)
20 Respondent asserts that an IPO is not a condition of granting, citing Treasury Regulation section
21 1.83-7(a) in saying, "If section 83(a) does not apply to the grant of such an option because the option
22 does not have a readily ascertainable fair market value at the time of grant, section 83(a) and 83(b) shall
23 _____

24 ¹³ Respondent contends that it did not rely upon appellants' recreated calendars submitted at protest because the calendars did
25 not align with the contemporaneous travel documents, appellants have not provided any additional substantiation to support
26 the alternative calendars, and the recreated calendars actually conflict with appellants' assertions on appeal. (Resp. Op. Br.,
pp. 11-12.)

27 ¹⁴ Respondent refers to similar arguments to refute appellants' alternative assertion that the relevant period for the stock
28 option income should be the twelve months immediately prior to the exercise date, which was the period under the SOA used
to determine the value of the company and thereby the amount of shares exercisable. Respondent asserts that this 12-month
period is not reflective of the 29-month period in which appellant-husband performed services under the option agreement.
(Resp. Reply Br., p. 5.)

1 apply at the time the option is exercised or otherwise disposed of” (Resp. Op. Br., p. 10.)

2 Applicable Law

3 Burden of Proof

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

13 California Taxation of Nonresidents

14 R&TC section 17041 provides that California imposes an income tax on the entire
15 taxable income of every nonresident to the extent that the nonresident derives the taxable income from
16 sources within California. R&TC section 17951 provides that, for purposes of computing California
17 taxable income, the gross income of nonresidents includes only their gross income from sources within
18 California. Compensation for personal services is sourced to the place where the services are
19 performed. (Cal. Code Regs., tit. 18, § 17951-2; *Appeal of Robert C. and Marian Thomas, supra.*) As
20 discussed below, stock options are considered compensation for personal services. (Int.Rev. Code,
21 § 83; *Commissioner v. LoBue* (1956) 351 U.S. 243.) The total compensation for personal services must
22 be apportioned between California and other states and foreign countries in which the individual was
23 employed in such a manner as to allocate to California that portion of the total compensation which is
24 reasonably attributable to personal services performed in California. (Cal. Code Regs., tit. 18,
25 § 17951-5, subd. (b).) What constitutes a reasonable apportionment method so as to properly limit a
26 taxpayer’s gross income to that earned “from sources within this State” pursuant to the dictates of
27 R&TC section 17951 must be based upon the facts and circumstances of each case. (*Appeal of*
28 *James B. and Linda Pesiri*, 89-SBE-027, Sept. 26, 1989.)

Appeal of Kevin H. Sullivan
And Claire K. Sullivan

NOT TO BE CITED AS PRECEDENT - Document prepared for Board
review. It does not represent the Board’s decision or opinion.

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

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

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

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

24 Reasonable Apportionment Method

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

28 In the *Appeal of Melvin A. and Adele R. Gustafson, supra*, the Board discussed the proper

1 apportionment method for a taxpayer's income from meat packing employment services. The issue
2 there was how much of a California credit was the taxpayer allowed for taxes paid to Nebraska. The
3 taxpayer argued that he spent a minimal amount of time performing his Nebraska services in California
4 (15-30 minutes by phone from California three times per week, plus two weeks presence in Nebraska).
5 On a strict time-based approach this equaled approximately 51.6 percent Nebraska time (i.e., 80 hours
6 Nebraska time to 75 California hours (90 minutes per week times 50 weeks)). Respondent originally
7 relied solely on the three-week presence in Nebraska and deemed the California personal services
8 rendered constituted 94.23 percent of the taxpayer's services (apparently 49 out of 52 weeks).
9 Respondent later concluded (declining to use the strictly time-based method) that the taxpayer should be
10 deemed to have worked in California for the Nebraska corporation for the same portion of the total year
11 as the Nebraska corporation's income bore to the taxpayer's total income, contending that the taxpayer
12 was compensated for his availability for consultations, not on a per minute basis. On these facts, the
13 Board stated that "where the respondent has applied a formula for [the] allocation of income, the
14 taxpayer bears the burden of showing that the application is intrinsically arbitrary or that it produced an
15 unreasonable result."

16 In the *Appeal of C. J. and Helen McKee* (68-SBE-023), decided by the Board on
17 May 7, 1968, the taxpayer was an Oregon resident who also operated a business in Oregon. During the
18 busy season, when the company generally earned its net profits, the taxpayer worked in Oregon. During
19 the off-season, when the company generally operated at a loss, the taxpayer spent time in California.
20 The taxpayer's salary, however, continued throughout the entire year, including the off-season. The
21 taxpayer also received annual bonuses, apparently based upon corporate profits. On his return, the
22 taxpayer sourced one-half of his salary to California, but none of his annual bonus to California.
23 Despite the fact that the taxpayer spent approximately one-half of each year in California, the Board
24 found that none of the bonus could reasonably be sourced to California because the bonus was based
25 upon the corporation's net profits and, during the off-season months, the corporation generally operated
26 at a loss while the taxpayer was in California. The Board noted that the corporation's net profits were
27 earned during the time when the taxpayer was present in Oregon and actively engaged in managing the
28 business. Thus, the Board determined that the bonus was attributable to sources outside of California.

Appeal of Kevin H. Sullivan
And Claire K. Sullivan

NOT TO BE CITED AS PRECEDENT - Document prepared for Board
review. It does not represent the Board's decision or opinion.

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

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

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

7 The allocation ratio is:

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

9 Income taxable by California = Total stock option income multiplied by Allocation ratio.
10

11 IRC Section 409A

12 IRC section 409A became effective January 1, 2005, and establishes specific terms for
13 nonqualified deferred compensation plans. The effect of violating the terms of this statute is to cause
14 the intended deferred gain to become taxable immediately plus a 20 percent penalty. The basic terms
15 of the statute are that the intended deferred compensation may not be distributed earlier than the time
16 specified under the plan at the date of the deferral of such compensation, or under other specific
17 conditions such as separation of service, disability, death, etc. (Int.Rev. Code, § 409A(a)(2)(A).) This
18 statute also includes various rules relating to the funding of deferred compensation plans.

19 The related Treasury Regulation, as it relates to the "date of grant of option," provides:

20 The language the date of grant of the option, and similar phrases, refer to the date when
21 the granting corporation completes the corporate action necessary to create the legally
22 binding right constituting the option. A corporate action creating the legally binding right
23 constituting the option is not considered complete until the date on which the maximum
24 number of shares that can be purchased under the option and the minimum exercise price
25 are fixed or determinable, and the class of underlying stock and the identity of the service
26 provider is designated. Ordinarily, if the corporate action provides for an immediate
27 offer of stock for sale to a service provider, or provides for a particular date on which
such offer is to be made, the date of the granting of the option is the date of such
corporate action if the offer is to be made immediately, or the date provided as the date of
the offer, as the case may be. However, an unreasonable delay in the giving of notice of
such offer to the service provider will be taken into account as indicating that the
corporation provided that the offer was to be made at the subsequent date on which such
notice is given.

28 (Treas. Reg. § 1.409A-1(b)(5)(vi)(B).)

Appeal of Kevin H. Sullivan
And Claire K. Sullivan

NOT TO BE CITED AS PRECEDENT - Document prepared for Board
review. It does not represent the Board's decision or opinion.

1 The issue of ascertaining the value of an option at the time of grant also appears in
2 Treasury Regulation section 1.83-7(a), which states that, when an “option does not have a readily
3 ascertainable fair market value at the time of grant, [IRC] sections 83(a) and 83(b) shall apply at the
4 time the option is exercised or otherwise disposed of” Treasury Regulation section 1.83-7(b)(2),
5 states that “. . . if an option is not actively traded on an established market, the option does not have a
6 readily ascertainable fair market value when granted unless the taxpayer can show [certain] conditions
7 exist. . . .”

8 STAFF COMMENTS

9 Respondent’s Concessions on Appeal

10 Respondent issued a Notice of Action for the 2007 tax year to appellants on May 3, 2012,
11 unrelated to the issues discussed in this summary.¹⁵ (Appeal Letter, exhibit 3.) Respondent has
12 indicated that it will withdraw that proposed assessment of \$164 plus interest. (Resp. Op. Br., p. 7,
13 fn. 8.)

14 Respondent’s original proposed assessments for 2007 and 2008 were \$3,930 and
15 \$444,304, respectively. On appeal, respondent adjusts those assessments by increasing the calculated
16 total workdays from August 1, 2005, through December 31, 2008, while also reducing the number of
17 California workdays over the same period. Respondent adjusted the calculation by allocating all
18 unaccounted for workdays after January 1, 2007, when appellants became nonresidents of California, to
19 Nevada (Resp. Op. Br., pp. 4-7), by including the previously disregarded months of July of 2007 and
20 April of 2008 (Resp. Reply Br., pp. 2-4), and by making calculation corrections to reduce the number of
21 California workdays by 4 (compare *Id.* at p. 2 to Resp. Op. Br., p. 4). The ultimate result of these
22 adjustments was to reduce the proposed assessments for 2007 and 2008 to \$2,632 and \$380,050,¹⁶

24 ¹⁵ This assessment was based on a federal adjustment to income from intangibles. Respondent states that since appellants
25 were not residents during 2007, there is no California tax liability for income from intangibles during that year. (Resp. Op.
26 Br., p. 7, fn. 8.)

27 ¹⁶ As appellants note in their supplemental brief, respondent made a technical error when reporting the revised 2008
28 proposed assessment. Respondent confirmed to the Appeal Division staff that the amount listed in the brief, i.e.,
\$434,532.11, was the amount of the proposed assessment plus interest up to the date of the reply brief. Appellants
performed their own calculations based on respondent’s concessions to reach \$380,063, and respondent has confirmed that
the actual proposed assessment amount as revised is slightly less than appellants’ estimate (i.e., \$380,050).

1 respectively.

2 Calculation of California and Total Workdays

3 In their reply brief, appellants state that, assuming respondent's method of allocating
4 2007 and 2008 income between California and Nevada is correct, it needed to be revised based on a
5 couple of points. Respondent has consented to those points, and adjusted the proposed assessments as
6 described above. Appellants should be prepared to state whether they now agree with the calculation of
7 workdays between California and states other than California, as provided by respondent in its reply
8 brief, if the Board were to find that respondent's allocation method is correct.

9 Appellants should also be prepared to state whether they assert error in respondent's
10 proposed assessments as they relate to the salary and bonus income, or if their only remaining
11 contention is with the taxation of the stock option income.

12 Stock Option Income

13 Appellants assert that the stock option income was granted and exercised while
14 appellants were nonresidents and, therefore, none of that income is taxable to California. The parties
15 should be prepared to discuss what portion of stock option income, if any, is taxable to California, even
16 if appellants are correct in their assertion regarding the grant and exercise date. In particular, the parties
17 will want to address the case law, publications, and regulations provided in this summary, and by
18 respondent, that appear to indicate that stock option income is to be reasonably apportioned to the states
19 where the services are performed, and that the California workdays over total workdays allocation
20 method has been shown to be a reasonable method of such apportionment.

21 The parties dispute which date should be used as the "grant date" of the stock option.
22 Appellants assert that the grant date cannot be earlier than the date that the definite number of shares
23 that appellant-husband could purchase under the option was known, which they assert is the date of
24 vesting and IPO on November 9, 2007, citing Treasury Regulation section 1.409A-1(b)(5)(vi)(B). The
25 language of the regulation refers to the grant date as the date when the maximum number of shares that
26 can be purchased is fixed or determinable. The parties should discuss whether the language of the
27 SOA, which provides a fixed and precise method for calculating the maximum number of shares that
28 will be purchasable, meets that regulation's description of requirements for the date of grant, or whether

1 the law requires that the definite *number* of shares must be known as of the grant date in addition to a
2 fixed calculation formula. The parties should also address the language of the SOA itself, which
3 appears to explicitly set the date of the agreement, August 1, 2005, as the grant date. The parties
4 should also address the fact that IRC section 409A addresses the issue of deferred compensation plan
5 failure and penalties, and why the Board should look to that section and accompanying regulation when
6 there was no plan failure in this instance. Instead, it appears as though IRC section 83(a) governs the
7 transaction, as asserted by respondent.

8 The parties should be prepared to discuss which date, if used as the grant date for
9 purposes of beginning the calculation for the percentage of income taxable to California, would best
10 represent a reasonable apportionment based on the facts. Respondent asserts that the SOA granted the
11 option to appellant-husband on August 1, 2005, and from that date until the date of exercise
12 appellant-husband was performing services toward the goal of maximizing his stock option income.
13 Therefore, respondent asserts, the workday calculations need to include the period of August 1, 2005,
14 through February 1, 2008.¹⁷ As noted above, appellant bears the burden of showing that respondent's
15 formula for the allocation of income is "intrinsically arbitrary or that it produce[s] an unreasonable
16 result." (*Appeal of Melvin A. and Adele R. Gustafson, supra.*) The parties should discuss and support
17 whether any other suggested start dates would provide a more accurate and reasonable apportionment
18 method under the facts, including mid-December of 2005 (when appellants assert the SOA was
19 ultimately signed), November 1, 2006 (so as to only include the 12-month period prior to the date of
20 vesting), or November 9, 2007 (when the option vested, became exercisable, and could no longer
21 increase in value).¹⁸

22 Sullivan_jj

23 _____
24
25 ¹⁷ The language of the SOA states that the stock option was being awarded in recognition of "services previously provided to
26 [LLI] during seven years of continuous employment," suggesting that the stock option was at least partially earned for
27 services provided by appellant-husband even before the August 1, 2005 date of the SOA.

28 ¹⁸ We note that the value of the stock option was determined and unchangeable as of November 9, 2007, when the option
vested. Therefore, appellant-husband's services from November 9, 2007, through the date of exercise, did not affect the
calculation of the stock option value. Appellants should discuss how this suggested period of service more accurately reflects
the period that appellant-husband's services were rendered toward the earning of the stock option value than respondent's
asserted period of service, which includes the time when appellant-husband's performance had an actual effect on the value
of the stock option to be awarded.

Appeal of Kevin H. Sullivan
And Claire K. Sullivan

NOT TO BE CITED AS PRECEDENT - Document prepared for Board
review. It does not represent the Board's decision or opinion.