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

10 In the Matter of the Appeal of:) **HEARING SUMMARY²**
11) **PERSONAL INCOME TAX APPEAL**
12 **RICHARD N. EISENBERG AND**) Case No. 610025
13 **ANITA EISENBERG¹**)
14 _____)

Year	Proposed Assessment of Additional Tax	Accuracy-Related Penalty
2007	\$562,524.00	\$112,504.80

18 Representing the Parties:
19 For Appellants: Steven R. Mather, Esq., Kajan Mather and Barish
20 For Franchise Tax Board: Maria Brosterhous, Tax Counsel

22 QUESTIONS: (1) Whether appellants have shown error in respondent's (Franchise Tax Board or
23 FTB) proposed assessment of additional tax based on the sourcing of a payment

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26 ¹ Appellants reside in Austin, Texas. Appellant-wife's maiden name, as reflected on transactional documents provided by the
27 party, appears to have been Anita Stewart.

28 ² This appeal was originally scheduled for the April 24, 2013 oral hearing calendar, and was deferred so the parties could
attempt to settle the matter. Negotiations were unsuccessful and this matter was re-scheduled for the August 5-7, 2014 oral
hearing calendar.

1 in which appellant-wife was entitled, pursuant to an employment contract.³

2 (2) Whether appellants have shown error in respondent's reduction of their itemized
3 deductions.

4 (3) Whether appellants have shown cause for the abatement of the accuracy-related
5 penalty.

6 HEARING SUMMARY

7 This appeal involves an amount in controversy that is \$500,000 or more and thus is
8 covered by Revenue and Taxation Code (R&TC) section 40. Please see Staff Comments below for
9 details.

10 Background

11 In 1999, Castalian Music, LLC (Castalian) was sold to Virgin Records America, Inc.⁴
12 (Virgin Records), and appellant-wife⁵ entered into an employment contract (Employment Agreement)
13 with Virgin Records on September 7, 1999, to serve as the president of Castalian for seven years.
14 (Response to Board Member Inquiry ("RBMI"), exhibit 1; Resp. Op. Br., exhibit A.) Castalian filed
15 California LLC returns for all tax years from 2000 through 2006, and filed as a nonapportioning
16 business for the tax years ending March 31, 2004, 2005, and 2006. In February of 2006, appellants
17 married, and they relocated to Texas as of July 31, 2006. Respondent asserts that appellant-wife was
18 allowed to work out of the Castalian office in Texas to continue performing her duties as president,
19 provided she maintained the same level of performance that she was providing while working in
20 California. (*Id.* at pp. 1-2 and exhibit E, p. 3.) Respondent states that during the seven-year contract as
21 president, appellant-wife worked approximately one month and six days as a resident of Texas (i.e.,
22 August 1, 2006, through the end of the contract, September 6, 2006). (Resp. Op. Br., p. 2.)

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25 ³ To the extent possible, this payment is referred to as the "Second Tranche payment" in this hearing summary. The parties refer to this payment variously, including also referring to the payment as the "Second Tranche incentive bonus."

26 ⁴ Virgin Records was sold to Thorn EMI, Inc., in 1992, several years prior to the 1999 sale of Castalian to Virgin Records. Appellants refer to the purchaser of Castalian as EMI in their Appeal Letter. To avoid confusion, this hearing summary will refer to the purchaser of Castalian as Virgin Records.

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28 ⁵ As mentioned above, at the time the parties entered into this agreement, appellant-wife was not married and her name was Anita Stewart.

1 The Purchase Agreement, dated September 7, 1999, provides the details of the sale of
2 Castalian Music by appellant-wife to Virgin Records.⁶ The Purchase Agreement transferred all of
3 appellant-wife's membership interests in Castalian for a total purchase price of \$3,550,000. (RBMI,
4 exhibit 1, pp. 1 & 5.) Appellant-wife and Virgin Records also entered into a Non-Compete Covenant on
5 that same date which provided a \$500,000 payment to appellant-wife in consideration of her agreeing to
6 not compete with Castalian after the sale for a period of one to two years, depending on performance
7 under the Employment Agreement. (RBMI, exhibit 2, pp. 1-2.)

8 Appellant-wife's Employment Agreement provided for an annual salary, yearly bonuses,
9 and an incentive bonus to be paid in two installments called the "First Tranche" and the "Second
10 Tranche." (Resp. Op. Br., exhibit A, pp. 2-7.) According to the contract, the First Tranche was
11 calculated based on pretax net earnings for, approximately, the first four years of the contract, and was
12 to be paid within 90 days of the last day of that computation period, August 31, 2003. The Second
13 Tranche was calculated based on the following three years of the contract and was to be paid within
14 90 days of August 31, 2006.⁷ (*Id.* at exhibit A, p. 4.) Respondent indicates that appellant-wife provided
15 documents showing that she was employed as the president of Castalian until October of 2006, assisted
16 with the transition of the new president of Castalian until January of 2007, and received a \$6,285,250
17 payment from Castalian on January 5, 2007. (*Id.* at p. 3.)

18 Respondent indicates that appellant-wife filed California resident returns for tax years
19 2000 and 2005, but did not file California returns for the 2001 through 2004 tax years. Appellants filed
20 a joint return as part-year residents for the 2006 tax year. (Resp. Op. Br., p. 3.) For the 2007 tax year,
21 the year at issue in this appeal, appellants filed a joint nonresident income tax return, reporting federal
22 wages of \$6,475,122, including \$6,285,250 in wages and other compensation received from Castalian in

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26 ⁶ The Purchase Agreement provides for the sale of Thirteen-Thirty-One LLC, wholly owned by appellant-wife, which
27 included wholly owned subsidiaries of the LLC such as Castalian Music. (RBMI at p. 1.) Terms in the Purchase Agreement
and Non-Compete Covenant discussed in this appeal as applying to Castalian also applied to Thirteen-Thirty-One LLC and
all entities owned by the LLC.

28 ⁷ The contract provides conditional terms which adjust the incentive bonus pay calculations and the dates of payment should
either party terminate the contract prior to the end of either of the computation periods. (Resp. Op. Br., exhibit A, pp. 4-7.)

1 2007.⁸ (*Id.* at exhibits B and D.) On appellants' Schedule CA, appellants reported that none of the
2 Castalian wages and compensation were California wages (i.e., income earned or received as a
3 California resident and income earned or received from California sources as a nonresident). (*Id.* at
4 exhibit C, p. 1.)

5 In February of 2010, respondent began its examination of appellants' 2007 return. (Resp.
6 Op. Br., p. 3.) Respondent states that information and documentation provided by appellants during
7 respondent's examination included a letter from appellants which states that the January 2007 payment
8 was made up entirely of a retention bonus, which appellants' representative clarified in a telephone call
9 the following day as the Second Tranche incentive bonus. Appellants also provided appellant-wife's
10 personal calendars for the three-year period relating to the Second Tranche, which indicated that
11 appellant-wife performed services for Castalian within and without California during those years. Based
12 on this information, respondent determined that a portion of the Second Tranche payment was
13 compensation for the performance of services in California and was thus California-sourced income.
14 (*Ibid.*) Respondent determined the portion of the payment that was subject to California taxation based
15 on the following chart (which is based upon days worked in each period):

Date Range	CA Days	Total Days	Percent in CA
Sept. 1, 2003 – Dec. 31, 2003	65	82	
Jan. 1, 2004 – Dec. 31, 2004	210	236	
Jan. 1, 2005 – Dec. 31, 2005	229	253	
Jan. 1, 2006 – Aug. 31, 2006	135	153	
Total:	639	724	88.2597%

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23 (*Id.* at p. 4.)

24 Respondent issued a Notice of Proposed Assessment (NPA) on December 28, 2010,
25 based on a finding that \$5,547,343 (i.e., 88.2597 percent) of the \$6,285,250 Second Tranche payment
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28 ⁸ The remaining \$189,872 of wage income (\$6,475,122 less \$6,285,250) appears to be from a W-2 from Weinstein Company Funding, LLC, and this amount is not at issue in this appeal. (Resp. Op. Br., pp. 2-3.)

1 was California-sourced income, and assessed additional tax of \$562,524, plus applicable interest.⁹
2 (Resp. Op. Br., exhibit F.) Based on the additional tax assessment, respondent's NPA also imposed an
3 accuracy-related penalty of \$112,504.80. (*Ibid.*) Appellants protested the NPA, and respondent
4 affirmed the NPA with a Notice of Action on April 26, 2012. (*Id.* at p. 4 and exhibit G.) This timely
5 appeal followed.

6 Contentions

7 Appellants' Contentions

8 Appellants assert that they were Texas residents on August 31, 2006 (i.e., at the
9 conclusion of the payment calculation period for the Second Tranche), and in January of 2007 when the
10 "Profit Payment" was made.¹⁰ (Appeal Letter, pp. 2-3.) Appellants assert that the Profit Payment arose
11 out of appellant-wife's sale of all of the Castalian-related entities to Virgin Records in 1999. Appellants
12 assert that appellant-wife received compensation for (1) her interests in the Castalian-related interests,
13 (2) a salary and annual performance bonus pursuant to the Employment Agreement, and (3) profit
14 payments made at specific dates in lieu of her continuing interest in Castalian based on the performance
15 of those entities. (*Id.* at p. 3.) Appellants assert that the Second Tranche payment became payable and
16 was received after appellants became Texas residents, and therefore no part of the payment can be
17 deemed taxable in California. Appellants contend that respondent is attempting to use the California
18 activity of an underlying entity (i.e., Castalian) to tax the income of a nonresident, which is expressly
19 prohibited by the United States Constitution. (*Id.* at p. 4; citing *Milhous v. Franchise Tax Board* (2005)
20 131 Cal.App.4th 1260.) Appellants contend that respondent incorrectly applied the method for
21 determining the portion of the Profit Payment that is California-sourced income, stating that
22 respondent's formula is factually groundless and conceptually flawed, and vastly overstates appellants'
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25 ⁹ The increase in taxable income resulted in a reduction of appellants' itemized deductions and an increase of the Mental
26 Health Services Tax, which are reflected in the proposed assessment of additional tax.

27 ¹⁰ Appellants call the January 2007 payment at issue a Profit Payment and an Ownership Interest payment in their briefing. It
28 appears as though these titles are referencing the Second Tranche incentive bonus, as it is listed in the Employment
Agreement between Castalian and appellant-wife. (See Resp. Op. Br., exhibit A.) At the hearing, the parties should clarify
whether any payment, other than the \$6,285,250 payment received in January of 2007, is at issue here.

1 taxable income.¹¹ (*Ibid.*)

2 Appellants contend that the itemized deduction adjustment was a result of respondent's
3 California-sourced income determination, and is incorrect since the underlying income determination is
4 erroneous. (Appeal Letter, p. 4.) Appellants assert that the accuracy-related penalty, which must either
5 be imposed based on a substantial understatement or negligence, is not properly imposed. Appellants
6 contend that their treatment of the Second Tranche payment and all relevant facts were clearly disclosed
7 on the return, and there was substantial authority for the position appellants took on their return.
8 Therefore, appellants contend that there was no substantial understatement and, regardless, appellants
9 have reasonable cause for waiving the penalty because they reasonably relied on the expert advice of
10 their tax professional regarding the complicated tax treatment of the payment. (*Id.* at p. 5; citing
11 *Vorsheck v. Commissioner* (9th Cir. 1991) 933 F.2d 757.) Appellants likewise state that the penalty
12 should not be imposed based on negligence since they sought advice from an expert and in no way can
13 be deemed to have acted unreasonably or in an imprudent manner. (Appeal Letter, pp. 5-6.)

14 Appellants assert that respondent's position is based entirely on an assumption that is
15 demonstrably false. Appellants contend that the payment was not payment for services, as contended by
16 respondent, and refers to a separate transaction that occurred in 1997 (i.e., the Westwood agreement) to
17 assert that the Profit Payment was a payment for the sale of appellant-wife's ownership interests in
18 Castalian according to industry standards.¹² (App. Reply Br.) Appellants indicate that appellant-wife's
19 annual compensation cap of \$2,000,000 per year included her salary and performance bonus
20 compensation, but not the ownership interest (i.e., Incentive Bonus), showing that the Profit Payment
21 was not a payment for services. (*Id.* at pp. 2-3; Resp. Op. Br., exhibit A, p. 3.) Appellants assert that in
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23 ¹¹ Appellants mention that they may be entitled to a partial refund for the performance bonus compensation since it might be
24 considered a payment for appellant-wife's ownership interest. (App. Reply Br., p. 2.) This contention is not developed
25 beyond a short statement and, ultimately, is not at issue in this appeal.

26 ¹² The Westwood agreement used as an analogous example by appellants was between appellant-wife and Virgin Records
27 and entered into in December of 1997. (App. Reply Br., exhibit 2.) This transaction was for the sale of appellant-wife's
28 interest in Westwood Promotions, Inc., and did not include any continuing employment obligation. Appellant subsequently
provided a Mutual Release Agreement between appellant-wife and Virgin Records wherein the parties were released from
their obligations under the Westwood agreement. (App. Supp. Br., exhibit.) The Mutual Release Agreement is dated
September 7, 1999, the same date as appellant-wife's Employment Agreement with Castalian following the sale of Castalian
to Virgin Records.

1 typical recording industry ownership sales, the amount paid depends on future profits, and the Profit
2 Payment at issue in this appeal was a payment for appellant-wife's ownership interest in Castalian.
3 (App. Reply Br., p. 3.) Appellants state that respondent's theory in this appeal is only viable if the
4 ownership interest payment is compensation for services, and contend that the facts do not support
5 respondent's treatment of the payment. (App. Supp. Br.)¹³

6 Respondent's Contentions

7 Respondent asserts that the source of income is determined by examining the location in
8 which services are performed without regard to the taxpayer's residency.¹⁴ (Resp. Op. Br., p. 4, citing
9 the *Appeal of Charles W. and Mary D. Perelle*, 58-SBE-057, decided by the Board on December 17,
10 1958.) Respondent contends that, except for one month, appellant-wife resided in California from
11 September 1, 2003, through August 31, 2006, and even though she received the bonus while a Texas
12 resident in 2007, a portion of the compensation that she received for those services is taxable California-
13 sourced income because it was compensation for services performed in California. (*Id.* at p. 5.)

14 Respondent asserts that there is no evidence that the Second Tranche payment was anything other than
15 an incentive bonus, noting that the payment is referred to as an incentive bonus in the Employment
16 Agreement and there is no indication in the agreement that this is a profit payment or a payment in lieu
17 of appellant-wife's interest in Castalian. Respondent also notes that Castalian reported the bonus as
18 compensation on the Form W-2, further confirming that the payment was a bonus payment and not a
19 profit payment. (*Id.* at p. 6.)

20 Respondent asserts that the taxable income of a nonresident is allocated as set forth in the
21 California Code of Regulations and R&TC section 17954. Respondent asserts that, according to
22 California law, nonresident employees are taxed based upon a ratio weighing the total number of days
23 employed within the state versus the total number of days employed both within and without the state.
24 (Resp. Op. Br., p. 6.) Respondent asserts that appellant-wife was performing personal services in

26 ¹³ Appellants filed a "Response to FTB Reply Brief," dated November 14, 2012. This brief is being cited to as Appellants'
27 Supplemental Brief in this hearing summary.

28 ¹⁴ Respondent states that appellant appears to be suggesting that the accrual method of taxation applies, so that the income is
entirely sourced at the time the payment amount became fixed. Respondent asserts that the accrual method was repealed in
California under R&TC section 17554 in 2003. (Resp. Op. Br., p. 6, fn. 12.)

1 California during the 2003 through 2006 tax years, and the bonus pay she received must be allocated in
2 accordance with the total number of days worked in California versus days worked outside of California.
3 Respondent asserts that it correctly determined that approximately 88.26 percent of appellant-wife's
4 total services were performed within California, and it correctly used this ratio to determine appellants'
5 California tax liability regarding the bonus pay. (Resp. Op. Br., p. 7.) Respondent asserts that no part of
6 the Employment Agreement stipulates that any part of the performance must take place in Texas or that
7 payment was in any way connected to Texas. Respondent notes that the recalculation clauses in the
8 agreement merely state that, should the employment be terminated prematurely, appellant would be paid
9 for the portion of services completed. (*Ibid.*)

10 Respondent contends that the itemized deductions were properly adjusted because of the
11 overall limitation on deductions based on a taxpayer's adjusted gross income (AGI). (Resp. Op. Br.,
12 p. 8.) Respondent states that the accuracy-related penalty is based on the substantial understatement of
13 income. Respondent asserts that appellants reported a net tax liability of \$426,991 for the 2007 tax year,
14 but understated their tax liability by \$562,524. Respondent contends that appellants understated their
15 California income by more than 50 percent, and therefore the penalty was properly imposed. (*Id.* at
16 p. 8.) Respondent asserts that appellants do not meet the requirements for an abatement of the penalty.
17 (*Id.* at pp. 8-11.) Respondent contends that appellant-wife was fluent in financial and business manners,
18 being the president of a multi-million dollar record company, and negotiated and accepted the terms of
19 the employment agreement which provided that the bonus payment at issue was compensation for
20 services. (*Id.* at p. 11.)

21 Respondent addresses appellants' contention that the payment at issue is based upon a
22 standard music industry formula used for the sale of an intangible rather than California-sourced
23 compensation. (Resp. Reply Br., p. 1.) Respondent asserts that appellants' unrelated Westwood
24 agreement used as an analogy of industry practices is unrelated to the transaction at issue in this appeal,
25 and that one contract is not reflective of the entire industry. Respondent discusses the differences
26 between the Employment Agreement and the Westwood agreement offered as an example, noting that
27 the Westwood agreement specifically alludes to a stock sale, whereas the Castalian agreement has no
28 reference to the sale of stock and, instead, contains a number of references to matters specific to

1 compensation for employment. (*Ibid.*) Respondent contends that the Castalian Employment Agreement
2 was solely compensation for the performance of services and not a stock sale, and notes that the letter
3 provided by appellants discussing the potential sale of Castalian to Virgin Records is merely an offer
4 subject to negotiation and is not indicative of the final terms as executed in the Employment Agreement.
5 (*Id.* at p. 2.) Respondent alleges that the exclusion of the Second Tranche payment from the \$2,000,000
6 annual compensation limit does not preclude the payment from still being compensation for services
7 rendered. Respondent contends, rather, that the incentive bonus is not included in the annual limitation
8 because it was not paid on an annual basis like the other payments in the Employment Agreement.
9 (*Ibid.*)

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*,
17 88-SBE-027, decided by the Board on November 29, 1988, the Board held that, in the context of
18 reviewing respondent's method of allocating a taxpayer's income from services, the taxpayer bears the
19 burden of showing that the application is intrinsically arbitrary or that it produces an unreasonable result.

20 California Taxation of Nonresidents

21 R&TC section 17041 provides that California imposes an income tax on the entire
22 taxable income of every nonresident to the extent that the nonresident derives the taxable income from
23 sources within California. R&TC section 17951 provides that, for purposes of computing California
24 taxable income, the gross income of nonresidents includes only their gross income from sources within
25 California. Compensation for personal services is sourced to the place where the services are
26 performed. (Cal. Code Regs., tit. 18, § 17951-2; *Appeal of Robert C. and Marian Thomas*, 55-SBE-006,
27 April 20, 1955.) The total compensation for personal services must be apportioned between California
28 and other states and foreign countries in which the individual was employed in such a manner as to

1 allocate to California that portion of the total compensation which is reasonably attributable to personal
2 services performed in California. (Cal. Code Regs., tit. 18, § 17951-5, subd. (b).) What constitutes a
3 reasonable apportionment method so as to properly limit a taxpayer's gross income to that earned "from
4 sources within this State" pursuant to the dictates of R&TC section 17951 must be based upon the facts
5 and circumstances of each case. (*Appeal of James B. and Linda Pesiri*, 89-SBE-027, Sept. 26, 1989.)

6 R&TC section 17952 provides that a nonresident's income from stocks, bonds, notes, or
7 other intangible personal property is not income from sources within this state unless the property has
8 acquired a business situs in this state.¹⁵ California Code of Regulations, title 18, section (Regulation)
9 17952, subdivision (d), provides that the source of gains and losses from the sale or other disposition of
10 intangible personal property, including stock, is determined at the time of the sale or disposition of that
11 property.¹⁶ "For example, if a California resident sells intangible personal property under the
12 installment method, and subsequently becomes a nonresident, any later recognized gain attributable to
13 any installment payment receipts relating to that sale will be sourced to California." (*Ibid.*) R&TC
14 section 17951 provides specific instructions for how a nonresident taxpayer should treat his or her
15 California-source income. Pursuant to Regulation 17951-2, compensation for personal services is
16 sourced to the place where the services are performed and, pursuant to Regulation 17951-5, subdivision
17 (b), compensation for services must be allocated based on a reasonable apportionment method.

18 Reasonable Apportionment Method

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

22 In the *Appeal of Charles W. and Mary D. Perelle, supra*, the taxpayer, who was then a
23 California resident, entered into an employment contract in July 1944 by which he agreed to work
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26 ¹⁵ If the intangible personal property of a nonresident has acquired a business situs in California, then the entire income from
27 the property, including gains from the sale of the property, regardless of where the sale is consummated, is income from
28 sources within California and is taxable to the nonresident. (Cal. Code Regs., tit. 18, § 17952, subd. (c).)

¹⁶ Subdivision (d) of Regulation 17952 was added to the regulation, and became operative, on August 1, 2007. According to
R&TC section 19503, subdivision (b)(1), ". . . no regulation . . . shall apply to any taxable year ending before the date on
which any notice substantially describing the expected contents of any regulation is issued to the public." Since subdivision
(d) of Regulation 17952 became operative before the end of 2007, the regulation applies to the tax year at issue in this appeal.

1 exclusively for his employer's corporation for a period of five years. In September 1944, the taxpayer
2 received a five-year option to purchase 10,000 shares of stock at a market price designated by him. In
3 December 1945, the taxpayer ceased to work for the employer and, in March or April of 1946, he was
4 hired by a Michigan employer. In July 1946, he moved to Michigan. In September of that year, the
5 taxpayer sold his stock option back to the corporation for \$250,000. On its books, the corporation
6 treated this sum as compensation. Relying upon the United States Supreme Court's decision in *LoBue*,
7 the Board held that the gain on the sale of the option was compensation for services. (See
8 *Commissioner v. LoBue* (1956) 351 U.S. 243.) Because the services were performed in California, the
9 gain was taxable by California despite the taxpayers' status as Michigan residents at the time they sold
10 their option.

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

27 In the *Appeal of C. J. and Helen McKee* (68-SBE-023), decided by the Board on May 7,
28 1968, the taxpayer was an Oregon resident who also operated a business in Oregon. During the busy

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

12 Constitutionality of the Assessment

13 Regarding the issue of constitutionality, the United States Constitution gives Congress
14 the power to regulate commerce between the states. (U.S. Const., art. I, § 8, cl. 3.) However, the
15 California Constitution prohibits, in pertinent part, an administrative agency from refusing to enforce a
16 statute unless an appellate court has determined that the statute is unconstitutional. (Cal. Const., art. III,
17 § 3.5.) Furthermore, the Board has a well-established policy of abstaining from deciding constitutional
18 issues. (Cal. Code Regs., tit. 18, § 5412, subd. (b); *Appeal of Aimor Corp.*, 83-SBE-221, Oct. 26, 1983;
19 *Appeal of Vortex Manufacturing Co.*, 30-SBE-017, Aug. 4, 1930.) This policy is based upon the
20 absence of any specific statutory authority which would allow respondent to obtain judicial review in
21 such cases and upon our belief that judicial review should be available for questions of constitutional
22 importance. (*See Appeal of Aimor Corp.*, *supra*; *Appeal of Vortex Manufacturing Co.*, *supra*.)

23 Accuracy-Related Penalty

24 R&TC section 19164 provides for an accuracy-related penalty determined in accordance
25 with IRC section 6662. R&TC section 19164, which incorporates the provisions of IRC section 6662,
26 provides for an accuracy-related penalty of 20 percent of the applicable underpayment. The penalty
27 applies to the portion of the underpayment attributable to negligence or a disregard of rules and
28 regulations or to any substantial understatement of income tax. (Int.Rev. Code, § 6662(b).) The

1 Internal Revenue Code defines “negligence” to include “any failure to make a reasonable attempt to
2 comply” with the provisions of the Code. (Int.Rev. Code, § 6662(c).) The term “disregard” is defined
3 to include any “careless, reckless, or intentional disregard.” (*Ibid.*) There is a “substantial
4 understatement of income tax” when the amount of the understatement for a taxable year exceeds the
5 greater of ten percent of the tax required to be shown on the return, or \$5,000. (Int.Rev. Code,
6 § 6662(d)(1).) Unless an appellant shows that one of the exceptions is applicable, respondent properly
7 imposed the penalty. There are three exceptions to the imposition of the accuracy-related penalty. The
8 taxpayer bears the burden of proving that any defenses exist, such as substantial authority, adequate
9 disclosure and reasonable basis, and reasonable cause and good faith. (*Recovery Group, Inc. v.*
10 *Comm’r*, T.C. Memo 2010-76.)

11 An accuracy-related penalty shall not be imposed as to any portion of an underpayment
12 as to which an appellant shows there is reasonable cause and the taxpayer acted in good faith. (Rev. &
13 Tax. Code, § 19164, subd. (d); Int.Rev. Code, § 6664(c)(1); Cal. Code Regs., tit. 18, § 19164, subd. (a).)
14 Treasury Regulation section 1.6664-4(b)(1) provides in part:

15 The determination of whether a taxpayer acted with reasonable cause and in good faith is
16 made on a case-by-case basis, taking into account all pertinent facts and circumstances.
17 . . . Generally, the most important factor is the extent of the taxpayer’s effort to assess
18 the taxpayer’s proper tax liability. Circumstances that may indicate reasonable cause and
19 good faith include an honest misunderstanding of fact or law that is reasonable in light of
20 all the facts and circumstances, including the experience, knowledge and education of the
21 taxpayer. . . .

22 Treasury Regulation section 1.6664-4(c)(1)(ii) provides that the advice must not be based on
23 unreasonable factual or legal assumptions (including assumptions regarding future events) and must not
24 unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any
25 other person. That regulation further states, as an example, that the advice must not be based on a
26 representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such
27 as an inaccurate representation or assumption regarding the taxpayer’s purposes for entering into a
28 transaction or for structuring a transaction in a particular manner.

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1 STAFF COMMENTS

2 Proposed Assessment

3 The proposed assessment at issue is based on the sourcing of the \$6,285,250 Second
4 Tranche payment received by appellant-wife on January 5, 2007, in accordance with the Incentive
5 Bonus clause of the Employment Agreement entered into on September 7, 1999. Appellants contend
6 that the entire amount is not taxable in California, based on their change of residency to Texas as of
7 July 31, 2006. Respondent contends that \$5,547,343 (i.e., 88.2597 percent) of the \$6,285,250 amount is
8 taxable in California based on the percentage of work days that appellant-wife performed services in
9 California during the three-year period upon which the payment calculation was based.

10 The Second Tranche payment was made in accordance with appellant-wife's
11 Employment Agreement with Castalian (recently acquired by Virgin Records), and is found under the
12 Compensation and Benefits section of the agreement, under the heading "Incentive Bonus." The
13 Second Tranche payment is described as an incentive bonus payment based on the pretax net earnings of
14 Castalian during the final three-year period for which appellant-wife was serving as the president of
15 Castalian. In addition to this incentive bonus, appellant also received under the contract an annual
16 "Salary" and "Yearly Bonuses." The yearly bonuses are computed, in part, on the pretax net earnings of
17 Castalian in excess of \$3,400,000 and \$6,000,000, as well as a fixed rate per unit sold.¹⁷ Nothing in the
18 Employment Agreement appears to indicate that these incentive bonuses were compensation for the sale
19 of stock or for any continuing ownership interest in Castalian.

20 On the face of the document, it appears that the incentive bonus payments (i.e., the
21 First Tranche and the Second Tranche) were performance-based bonuses that were earned through
22 appellant-wife's services as the president of Castalian during the three-year calculation period, and were
23 calculated based on Castalian's financial success under her leadership. Appellants argue that the fact
24

25 ¹⁷ Two of the four yearly bonuses provided for in this section of the agreement explicitly reference Westwood, a company
26 appellant-wife previously sold to Virgin Records in the Westwood agreement. When appellant-wife entered into this
27 Employment Agreement with Virgin Records, the parties also entered into a Mutual Release Agreement on the same date to
28 release each party from the obligations under the Westwood agreement. It does not appear that these yearly bonuses are
included as a continuance of any of the royalties that appellant-wife was receiving under the Westwood agreement.
Appellants should be prepared to disclose any overlap between the payment rights that appellant-wife was receiving under
the Westwood agreement, that were released, and new payments received under the Castalian Employment Agreement. (See
App. Reply Br., exhibit 2, pp. 8-14; Resp. Op. Br., exhibit A, pp. 2-3.)

1 these incentive bonuses were contractually exempt from the \$2,000,000 per year earnings cap placed on
2 appellant-wife's salary and yearly bonuses indicates that the bonuses were not compensation for
3 services. However, it is not clear to staff how such a contractual limitation on salary and annual bonuses
4 is relevant to whether another category of compensation, the incentive bonuses at issue here, constitutes
5 payment for services. Also, it is not clear to staff how the fact that the calculation of the incentive
6 bonuses would have been altered had either party prematurely ended the Employment Agreement
7 supports an argument that the incentive bonuses were paid for appellant-wife's ownership interests in
8 Castalian rather than payment for services. Appellant references the unrelated Westwood agreement as
9 an example in an effort to assert that the incentive bonus formula is the industry standard formula for the
10 sale of stock. However, the Westwood agreement expressly involved the calculation of "purchase price"
11 paid in return for a sale of stock, rather than an incentive bonus paid pursuant to an Employment
12 Agreement.

13 Pursuant to a Board Member inquiry, appellant provided the Purchase Agreement and
14 Non-Compete Covenant. (RBMI.) From a review of the documents provided, it appears that (1) the
15 Purchase Agreement constitutes the entire compensation provided to appellant-wife for the sale of her
16 interests in Castalian to Virgin Records, (2) the Employment Agreement provides compensation for her
17 services rendered as an employee of Virgin Records after the sale, and (3) the Non-Compete Covenant
18 provided compensation for appellant's agreement to not compete with Castalian's business after it was
19 sold to Virgin Records. Since the Purchase Agreement and the Non-Compete Covenant were provided
20 after the conclusion of briefing, the parties should be prepared to discuss what these payments represent
21 and whether the Purchase Agreement and the Non-Compete Covenant support respondent's finding that
22 the Second Tranche payment was for services rendered and not compensation for the sale of her interests
23 in Castalian.

24 Respondent used a formula that determines the percentage of the Second Tranche
25 payment that is taxable in California based on the number of work days appellant-wife performed
26 services in California, divided by the total number of work days over the three-year calculation period.
27 This formula is similar to formulas used to determine California taxability in situations involving
28 non-qualified stock options and the examples listed in Regulation 17951-5. At the hearing, appellants

1 have the burden of demonstrating that this method, which applies a work day methodology that is
2 routinely used by respondent, is unreasonable.¹⁸

3 Appellants assert that respondent's sourcing of the Second Tranche payment is incorrect,
4 since it attempts to use the California activity of Castalian to tax the income of a nonresident.
5 Appellants cite to the California Court of Appeal decision in *Milhous, supra*, in which the nonresident
6 taxpayers never conducted businesses in California, but rather gave up a valuable opportunity to conduct
7 business in California through a covenant not to compete. The Franchise Tax Board argued in *Milhous*
8 that, even though the covenant had no actual value in California, an apportioned share was still taxable
9 to California because the covenant accompanied the sale of a California company that the taxpayers
10 owned (i.e., arguing that the intangible had situs in California). The court reasoned that the covenant
11 was not paid for by the California company nor gave up rights in the California company, but instead
12 gave up the rights of the taxpayers themselves, and therefore had no situs in California. The court
13 determined that no part of the covenant payments arose from activities in California or from capital
14 which is located in California. In the present appeal, appellant-wife did perform services in California
15 during the calculation period for the Second Tranche payment, and any related intangibles would be
16 those of Castalian, which appears to have been a California company with situs in California.
17 Therefore, it appears to staff that *Milhous, supra*, is distinguishable.

18 If appellants are able to substantiate with evidence their contention that the Second
19 Tranche payment was entirely for an intangible interest (i.e., ownership interests or stock in Castalian),
20 and not for services performed, the Board will still need to determine whether the sale of the intangibles
21 is California-sourced income. Regulation 17952, subdivision (d), provides that the source of gain from
22

23 ¹⁸ The issue before the Board is whether respondent's method of calculation produces an unreasonable result or is
24 "intrinsically arbitrary." (See *Appeal of Gustafson, supra*.) Staff notes that respondent's sourcing method effectively treats
25 appellant-wife as a nonresident of California for the entire three-year calculation period even though it appears she was only a
nonresident for approximately five weeks.

26 Respondent states in its opening brief that appellant-wife filed resident returns for the 2000 and 2005 tax years, but did not
27 file California returns for tax years 2001 through 2004. Castalian filed LLC returns for tax years 2001 through 2004, and
28 appellant-wife appears to have been employed in California and earning wages (as the president of Castalian) according to
the Employment Agreement with Castalian from 2001 through 2004. Therefore, it appears that appellant-wife had a
California filing obligation during these years. The parties should be prepared to discuss why appellant-wife did not file
California returns for 2001, 2002, 2003, and 2004.

1 the sale of stock or other intangible personal property is determined at the time of the sale or disposition,
2 regardless of whether payments are received later. Here, appellant-wife's ownership interest, i.e., stock,
3 in Castalian appears to have been sold or otherwise transferred to Virgin Records in 1999.¹⁹ If the
4 Board determines that the incentive bonus was paid for an intangible, the parties should be prepared to
5 discuss whether the intangible was sold while appellants were California residents and therefore would
6 still constitute California-source income.²⁰

7 The increase of AGI reflected in respondent's proposed assessment resulted in an
8 accuracy-related penalty based on the substantial understatement of income. The increase in AGI also
9 resulted in an increase in the Mental Health Services Tax, which is imposed at the rate of one percent on
10 the portion of a taxpayer's taxable income in excess of one million dollars, and the phasing out of
11 itemized deductions. Under R&TC section 17077, otherwise allowable itemized deductions of high
12 income taxpayers are reduced by the lesser of (i) 6 percent of the excess of AGI over a threshold amount
13 or (ii) 80 percent of the amount of itemized deductions otherwise allowable for the tax year. Should
14 appellants prevail in whole or in part on the proposed assessment issue, these two items will be adjusted
15 accordingly.

16 Accuracy-Related Penalty

17 Appellants contend that the accuracy-related penalty should be abated. Respondent
18 asserts that the penalty is imposed based on a substantial underpayment of income. Therefore,
19 appellants will need to provide evidence to receive relief under one of the following three provisions:
20 (1) substantial authority (Treas. Reg. § 1.6662-4(d)); (2) adequate disclosure and reasonable basis
21 (Treas. Reg. § 1.6662-4(e)); or (3) reasonable cause and good faith (Treas. Reg. § 1.6664-4(c)(1)).

22 Appellants assert that there was substantial authority for the treatment of the income as
23 reported on their 2007 return by contending that the overwhelming weight of the evidence shows that
24

25 ¹⁹ The Employment Agreement, entered into in September of 1999, clearly states in the opening page that Virgin Records
26 was the parent of Castalian at the time the parties entered into that agreement. (Resp. Op. Br., exhibit A, p. 1.)

27 ²⁰ If appellants are able to provide evidence showing that the payment was compensation for the sale of an intangible and not
28 compensation for services, and that the actual sale of the intangible occurred after appellants ceased being California
residents, rather than in 1999, then appellants should be prepared to explain the nature of the intangible they contend the
Second Tranche payment was for and whether the intangible had a business situs in California. (See Rev. & Tax. Code,
§ 17952; Cal. Code Regs., tit. 18, § 17952, subd. (c).)

1 the payment was not California-sourced. To show that the penalty should be abated based on substantial
2 authority, appellants should provide legal authority, including case law, to show that there is substantial
3 authority for their treatment of the payment, rather than relying upon their statements and interpretations
4 of the facts.

5 Appellants also assert that the income and sourcing was clearly set forth on their return,
6 along with the disclosure of all of the relevant facts. Treasury Regulation section 1.6662-3(c) provides
7 that adequate disclosure applies when a position contrary to a rule or regulation is taken by a taxpayer,
8 and this position is disclosed according to subsection (c)(2) of that same regulation. This provision also
9 requires that there is reasonable basis for the position taken. Reasonable basis is “a relatively high
10 standard of tax reporting,” and “is not satisfied by a return position that is merely arguable or that is
11 merely a colorable claim.” (*Id.* at subsection (b)(3).) To successfully show that the penalty should be
12 abated, appellants need to show that they meet the standards expressed under this Treasury Regulation.

13 Appellants cite to *Vorsheck, supra*, to support their contention that there is reasonable
14 cause for waiving the penalty because they relied upon the advice of their CPA to address the
15 complicated tax issue. The Ninth Circuit Court of Appeals (“Ninth Circuit”) concluded in *Vorsheck,*
16 *supra*, that the accuracy-related penalty, which was imposed under the predecessor statute to IRC
17 section 6662, should be abated because the taxpayers there were unsophisticated about business and tax
18 matters and reasonably and in good faith relied upon the advice of their tax advisor about a tax shelter.
19 Unlike the taxpayers in *Vorsheck*, appellant-wife was the president of a multi-million dollar record
20 company, who had entered into previous large-scale transactions, and appears fluent in financial and
21 business matters. Appellants’ sophistication and business experience, knowledge, and education must
22 be taken into account when determining whether appellants acted with reasonable cause and in good
23 faith. Appellants should provide evidence or otherwise show that they fully disclosed the terms of the
24 Employment Agreement to their tax preparer, that the tax preparer had knowledge of the relevant
25 aspects of California law, and that the position taken did not involve any unreasonable assumptions or
26 result in a position that appellants knew or had reason to know was unlikely to be accurate. (See *Treas.*
27 *Reg. § 1.6664-4(c).*)

28 ///

1 Section 40

2 As noted above, this matter is subject to Revenue and Taxation Code section 40.
3 Therefore, within 120 days from the date the Board's vote to decide the appeal becomes final, a written
4 opinion (i.e., Summary Decision or Formal Opinion) must be published on the Board's website.
5 (Cal. Code Regs., tit. 18, § 5552, subs. (b), (f).) The Board's vote to decide the appeal will become
6 final 30 days following the date of the Board's vote, except when a petition for rehearing is filed within
7 that period.²¹ (Cal. Code Regs., tit. 18, § 5460, subd. (a).)

8 Following the conclusion of this hearing, if the Board votes to decide the appeal, but
9 does not specify whether a Summary Decision or a Formal Opinion should be prepared, staff will
10 expeditiously prepare a nonprecedential Summary Decision and submit it to the Board for
11 consideration at a subsequent meeting. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(2).) Unless the
12 Board directs otherwise, the proposed Summary Decision would not be confidential pending its
13 consideration by the Board (Cal. Code Regs., tit. 18 § 5551, subd. (b)(5)); accordingly, it would be
14 posted on the Public Agenda Notice for the meeting at which the Board will consider and vote on the
15 Summary Decision.

16 A taxpayer may request that the Board hold in abeyance its vote to decide the appeal so
17 the taxpayer may review the Board's written opinion prior to the expiration of the 30-day period for the
18 filing of a petition for rehearing. If the vote is held in abeyance, the proposed Summary Decision will
19 be confidential until it is adopted by the Board. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(5).) Any
20 request that the Board's vote be held in abeyance should be made in writing to the Board Proceedings
21 Division prior to the hearing or as part of oral argument at the hearing. Any such request would then be
22 considered by the Board during its deliberations on the appeal.

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26 Eisenberg_jj

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28 ²¹ If a petition for rehearing is filed, the Board's decision will not become final, and no written opinion under Section 40 will be considered until after the petition for rehearing is resolved.