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7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**
9

10 In the Matter of the Appeal of:) **REHEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **TODD BENTLEY AND KATE BENTLEY**) Case No. 593582
13)

	<u>Year</u>	<u>Proposed</u> <u>Assessments</u>
	2004	\$132,041
	2005	\$206,508

17 Representing the Parties:

18 For Appellant: Robert J. Chicoine, Esq., Chicoine Law Group
19 For Franchise Tax Board: Natasha Sherwood Page, Tax Counsel III
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21 **QUESTION:** Whether appellants have shown that respondent Franchise Tax Board (respondent)
22 erroneously assessed additional tax based on the sourcing to California of income
23 arising from appellant-husband's¹ settlement of a lawsuit with his former employer.

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28 ¹ Hereinafter, appellant-husband will be referred to as "appellant".

1 REHEARING SUMMARY²

2 Background

3 Prior Hearing

4 The Board heard the original appeal of this matter on November 19, 2013, and
5 determined that appellants failed to show that respondent erroneously assessed additional tax based on
6 the sourcing to California of payments arising from the settlement of a lawsuit. Appellants filed a
7 Petition for Rehearing (PFR) in which they contend as the grounds for rehearing that there were
8 insufficient facts to justify the Board's decision and that the decision was contrary to law. Appellants
9 argue that, in accordance with case law precedent, this Board should have made a reasonable allocation
10 of the settlement payment between past wages and the covenant not to compete in view of the fact that
11 the settlement agreement was silent on this issue. Appellants maintain that the criteria for such an
12 allocation considered by the courts in those cases were present in this appeal as follows: substantial
13 credible evidence of a covenant not to compete and other rights relinquished by appellant, evidence of
14 the parties' intent that a large portion of the payment should compensate appellant for the covenant not
15 to compete and his relinquishment of those rights and evidence that the allocation of a "minimal"
16 portion of the payment for past wages is economically reasonable. Appellants also argue that the case
17 law cited by respondent did not support its position that, under the origin of the claim doctrine, the entire
18 settlement payment should be treated as a payment for past wages.

19 Factual Background

20 In 1998, appellant moved from Canada to California and worked out of a home office as
21 a commissioned sales representative for Great White North Ltd. of Livonia, Michigan, a package
22 delivery company. The company was partially owned by Global Mail Ltd., which was eventually
23 acquired by Deutsche Post and merged into Deutsche Post Global Mail (DPGM). (Appeal Letter (AL),
24 p. 2, App. Op. Br., p. 2.) In June of 2000, appellant entered into an employment agreement with
25 Global Mail Ltd. for a position as the Director of Strategic Accounts, Western Region.³ Pursuant to the
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28 ² This appeal is before the Board as a rehearing. The background facts contained herein are as provided by the parties for the original hearing.

³ The agreement entered into was terminated in April 2003.

1 agreement, appellant was paid a commission on the gross margin of each completed mailing for which
2 he quoted the customized rate, as well as additional bonus commissions called “kickers” if he met his
3 sales goals. (App. Op. Br., pp. 2-3 and Exhibit B.) Appellant solicited companies for international
4 mailing business related to advertising and parcel mail orders. (App. Op. Br., p. 2.) In addition to
5 preparing proposals and customizing quotes, he provided ongoing customer service to his clients and
6 worked directly with DPGM headquarters in Virginia from his home office in California. (AL, p. 2.)

7 In March 2001, appellant was part of the DPGM sales team that secured a two-year
8 agreement with Amazon.com (Amazon) which at the time was DPGM’s largest client and accounted for
9 a significant part of the company’s overall revenue. (App. Op. Br., pp. 3-4 and Exhibit 1.) Appellant
10 became the exclusive contact for all of Amazon’s business with DPGM and its subsidiaries and worked
11 on the Amazon account from March 2001 until April 2003 and, in early 2003, appellant was involved in
12 negotiations for another two-year agreement with Amazon. (AL, p. 3, App. Op. Br., pp. 3-4, Exhibit H.)
13 In March 2001, appellant and DPGM mutually agreed to amend appellant’s employment agreement to
14 reduce his base commission on the account from 13 percent to 6.5 percent but appellant understood that
15 the revised agreement retained the “kicker” part of his commission on all of his accounts, Amazon
16 included. Although appellant received the additional bonus payments in the second quarter of 2001,
17 appellant did not receive such payments in the third quarter of 2001 and a dispute ensued over the
18 unpaid commissions. (App. Op. Br., p. 4, Exhibits D and E.)

19 Appellant filed suit against DPGM in Los Angeles County Superior Court on April 3,
20 2003, alleging various causes of action⁴ and DPGM filed a countersuit. (App. Op. Br., pp. 5-6, Exhibits
21 L and N.) On April 11, 2003, just after appellant filed the lawsuit, the company cancelled the
22 employment agreement and rehired appellant as an at-will employee under a new agreement that
23 provided he would not work on the Amazon account. In 2004, appellant’s sales territory was restricted
24 by DPGM. (App. Op. Br., p. 5.)

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26 ⁴The complaint alleged a number of causes of action including: unpaid wages, breach of written contract, breach of implied
27 covenant of good faith and fair dealing, negligent misrepresentation, conversion, fraud, accounting, and constructive trust. In
28 April of 2004, appellant filed a second amended complaint which added additional causes of action of retaliation and
negligence per se. (Resp. Op. Br., Exhibit D.) Appellant first filed a complaint with the California Labor Commissioner.
(Resp. Op. Br., p. 3, Exhibit D, p.7.)

1 In August of 2004, appellant and his wife left California and relocated to Vancouver,
2 Washington, where appellant continued to work for DPGM from a home office. On November 2, 2004,
3 pursuant to an arbitration agreement, appellant and DPGM settled the lawsuit and communicated the
4 settlement to the court. The Confidential Settlement and Release Agreement (Settlement Agreement)
5 provided that appellant’s employment with DPGM was terminated effective November 2, 2004. (App.
6 Op. Br., p. 5.)

7 The Settlement Agreement provided that, for a total payment to appellant of \$5.3 million,
8 the parties would “discharge, compromise, settle, and resolve all of the claims in the Action and
9 cross-action and any other claims or causes of action that they may have or claim to have against each
10 other and agree as an essential and fundamentally material part of this Agreement that [appellant] will be
11 bound by the nonsolicitation provisions described.”⁵ The nonsolicitation provision in Section 13 stated
12 that appellant would not recruit employees or independent contractors of DPGM for one year and would
13 not solicit DPGM customers for six months, excluding appellant’s five major clients, and a recital to the
14 agreement indicated that this provision was an “essential and fundamentally material part of this
15 Agreement that Bentley will be bound by . . .”

16 Section 4 provided that a portion of the payments at issue⁶ would be reported on IRS
17 Form W-2 and that “part of the consideration the Company is providing to Bentley under this
18 Agreement is for the satisfaction of all claims made by him, including for alleged past and future lost
19 wages.” It stated that appellant represented he had a good faith, reasonable basis for asserting
20 Washington residency and that “the Company understands . . . that [Bentley] will apply for a refund with
21 the California Franchise Tax Board based on his belief that the Company will over withhold California
22 state taxes . . .” In Section 5, appellant agreed to indemnify DPGM from any tax incurred as a result of
23 relying on his Form W-4. (App. Op. Br., Exhibit S.)

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26 ⁵ In addition to settling all the complaints from the lawsuit, appellant gave up his right to any future employment with DPGM
or affiliated companies and signed a Supplemental Release Agreement giving up all claims under the federal Age
Discrimination in Employment Act of 1967, as amended. (App. Op. Br., Exhibit S.)

27 ⁶ As noted below, \$1.28 million was paid directly to appellant’s attorney and reported on Form 1099. Respondent’s
28 assessment does not include this amount, which respondent states was an error on its part, in that such amount should have
been included in respondent’s assessment. (See Resp. Op. Br., Exhibit L.)

1 The Settlement Agreement was finalized on December 17, 2004. Appellant provided
2 DPGM with a new Form W-4 and a declaration of his Washington residency. The payment was issued
3 as follows: \$3,000,000 was paid in December of 2004 including \$1,280,000 of attorney fees which were
4 reported on a Form 1099 to appellant's attorney with the remaining \$1,720,000 reported on appellant's
5 Form W-2 for 2004. A second payment of \$2,300,000 was paid in January of 2005 and reported on
6 appellant's Form W-2 for 2005. DPGM withheld California taxes on the \$4,020,000 payments issued to
7 appellant on his Forms W-2 for 2004 and 2005. (Resp. Op. Br., pp. 5-6.)

8 Appellants filed a Form 540NR part-year resident California return for 2004 and a Form
9 540NR non-resident California return for 2005. On the 2004 return, appellant reported federal adjusted
10 gross income (AGI) of \$1,827,436 but only \$74,247 in wages and \$76,901 in California AGI, with a
11 resulting tax liability of \$6,239. For 2005, appellant filed a non-resident return reporting \$2,483,141 in
12 federal AGI with no California-source income. Appellant received a refund of the entire amount for the
13 2004 and 2005 tax years. (Resp. Op. Br., p. 6).

14 Respondent subsequently audited the 2004 and 2005 returns and determined that
15 appellant's payments under the Settlement Agreement were properly California-source income as the
16 payments related to appellant's employment with DPGM. Respondent issued Notices of Proposed
17 Assessment (NPAs) on December 7, 2009, that reversed the refunded amounts for 2004 and 2005 and
18 imposed interest. (Resp. Op. Br., Exhibit K.) After a timely protest, on September 16, 2011, respondent
19 issued Notices of Action (NOAs) related to 2004 and 2005 that affirmed the assessments. Appellant
20 timely appealed the NOAs.

21 Contentions

22 Appellants' Rehearing Contentions

23 Appellants assert that respondent's position that the payments were California-source
24 income because there was no specific allocation in the Settlement Agreement and the underlying dispute
25 was employment-related is erroneous and contrary to law. Appellants contend that taxing authorities
26 should make a reasonable allocation of a settlement payment when the agreement is silent as to the
27 allocation between a covenant not to compete and other claims. Appellants further contend that the
28 "original of the claim doctrine does not trump the Board's obligation to make an allocation, if the

1 criteria established by the case law cited in the Petition for Rehearing are met.” Appellants assert that
2 sections 2 and 6 of the Settlement Agreement state that all past wages were paid in full, separate from
3 the additional payments in dispute. (Appellants’ Opening Rehearing Brief (App. Op. RHG Br.), pp. 3-4.)

4 Appellants contend that they have presented sufficient evidence to meet their burden of
5 proof of showing that the entire payment was not properly allocated to past wages and that the parties
6 intended a large portion for future wages, a covenant not to compete, and the release of other
7 non-taxable rights, including the following:

- 8 • Appellant’s annual salary ranged between \$100,000 and \$300,000 so the payment for past wages
9 was 17 times larger than his largest annual salary;
- 10 • The “kicker” or bonuses for the three and a half years that appellant worked for DPMG and the
11 Amazon account ranged between \$128,000 and \$200,000 per year. The future wages and growth
12 potential of the Amazon account were a significant reason for the dispute;
- 13 • The Settlement Agreement states the parties’ intent that the non-solicitation provision “was an
14 essential and fundamentally material part of the Agreement”;
- 15 • The Settlement Agreement states explicitly that the payment was in addition to any amount
16 appellant may have earned before November 5 when his employment terminated;
- 17 • DPMG calculated from its records that, at most, appellant was owed \$196,765 for the period in
18 dispute and the employer had overpaid him by \$124,000 during that period.

19 (App. Op. RHG Br., pp. 4-5.)

20 Appellants state that appellant worked for DPGM from 1998 through November of
21 2004, became a resident of Washington on August 6, 2004, and timely paid all California income tax
22 due. Appellants further state that, in March 2001, appellant “signed” the Amazon account and believed
23 that pursuant to a commission agreement he would be paid commissions plus kickers “for the Amazon
24 account based upon DPGM’s gross profit margin on the revenue generated from the Amazon account.”
25 Appellants state that DPGM took the position that appellant was entitled to kickers on all accounts
26 except Amazon and stopped paying kickers on the Amazon account after the first quarter of 2001.
27 Appellants assert that the parties had a good faith disagreement over the proper amount of
28 compensation. (App. Op. RHG Br., pp. 5-6.)

1 Appellants explain that kickers were calculated based on the previous 12 months of
2 appellant's total sales revenue and, for every \$1 million of revenue that appellant generated in the
3 previous 12 months, he would receive a kicker of 0.5 percent. The kicker percentage was multiplied by
4 the gross margin of appellant's accounts to determine a dollar amount for appellant's kicker payment.
5 Appellants state that they sued DPGM seeking damages, including past wages, and DPGM filed a
6 countersuit which alleged that appellant was overpaid and sought the repayment of those amounts. After
7 the parties reached a settlement, appellants assert that appellant tried to amend his Form W-4 but
8 DPGM's human resources department "would not respond." Appellants state that DPGM withheld
9 potential amounts of California income taxes from the settlement payments because "DPGM did not
10 want any exposure to taxing authorities" and appellant agreed "as a means of resolving the litigation."
11 (App. Op. RHG Br., pp. 6-8.)

12 Appellants assert that all wages due were paid timely upon appellant's resignation and
13 past wages were paid to the separation date as defined in the Settlement Agreement, which
14 acknowledged that no further wages were due. Appellants contend that the settlement payments were
15 amounts paid "in addition to past wages and included future wages, payment of a covenant not to
16 compete, non-solicitation of DPGM employees, non-disparagement, as well as releases from all claims."
17 Appellants state that they requested a refund of the withheld tax for the settlement payment made in
18 2004 which was granted. Appellants further state that they also requested a refund of the withheld tax
19 for the 2005 settlement payment and the full amount was eventually refunded. (App. Op. RHG Br., pp.
20 8-10.)

21 After respondent opened an audit of tax years 2004 and 2005, appellants state that they
22 requested, but did not receive, information about the person who handled their 2005 refund request, and
23 "the documents showing discussion on his refund amount for 2005 withholding." Appellants state that
24 the only document they received was a "redacted" screen shot that "clearly shows 'No CA Source
25 Income' on it." Appellants state that they were not represented when they dealt with respondent and
26 believes respondent's representatives were "disingenuous" because they encouraged them "to only tell
27 [their] story without citing any law, and they "totally ignor[ed] any wording in the Settlement Agreement
28 that indicated non-California sourced income" as respondent had originally concluded. (App. Op. RHG

1 Br., pp. 10-11.)

2 Appellants summarize the chronology of facts presented and argue that “for all of the
3 legal and factual reasons” cited in their petition and brief no portion of the settlement payments should
4 be treated as California-source income. If any portion is considered to be the payment for past wages
5 and, therefore, as California-source income, appellants contend that the amount should not be in excess
6 of \$400,000, which is the most “that can be reasonably allocated to taxable sources.” In further support
7 of their position, appellants point to sections 2 and 6 of the Settlement Agreement. (App. Op. RHG Br.,
8 pp. 12-13.)

9 Section 2, titled “Separation of Employment”, provides that appellant’s last day of
10 employment was November 2, 2004, and that on November 5, 2004, DPGM paid him “all accrued base
11 salary owed to him through the Separation Date, less required deductions and withholdings.” That
12 section also states that appellant claimed he was owed \$7,500 in commissions, less applicable
13 deductions and withholdings, through the separation date which DPGM disputed but agreed to pay,
14 provided that appellant agreed he was not entitled to any additional payments, except as otherwise stated
15 in the Settlement Agreement. Appellants assert that this section clearly states that all back wages have
16 been paid and that “subsequent settlement payments could not have been for past wages due.” (App. Op.
17 RHG Br., pp. 13-14.)

18 Section 6 titled “Acknowledgement by Bentley of Full and Timely Payment of Wages”,
19 provides that there was a “good faith dispute” over whether DPGM owed appellant any wages, that
20 under the Settlement Agreement appellant would be fully and timely paid all wages he alleged he
21 earned, and that the settlement payment constituted “consideration to him in an amount that is in
22 addition to any amount to which he is entitled.” That section also provided that appellant understood and
23 agreed that if “any release provided by him under this Agreement is deemed not to be fully valid and
24 binding on him, then he [would] not be entitled to receive any portion of the Settlement Payment from
25 [DPGM].” Appellants assert that, if past wages were not part of the additional settlement payments, it is
26 not economically reasonable or appropriate to allocate any portion of those payments to California-
27 source income. (App. Op. RHG Br., pp. 14-15.)

28 Appellants assert that back wages were paid to the date of separation in accordance with

1 California Labor Code section 206.5 and that pursuant to that code section the Settlement Agreement
2 would not have been legally enforceable unless all past wages and expenses were timely paid before
3 other payments were made. Furthermore, appellants contend that an employer cannot force an employee
4 to terminate his employment as a condition of receiving past wages due and, thus, the additional
5 payments “were not and could not have been for past wages as originally determined by the Board.”
6 (App. Op. RHG Br., pp. 15-16.)

7 Respondent’s Contentions

8 Respondent recites the factual and procedural background of this appeal. Respondent
9 states that appellants concede that “the Settlement Agreement did not specifically allocate the
10 consideration paid” and respondent agrees that “except for the reimbursement of his attorney fees, it is
11 clear that DPGM made a \$5.3 million payment for two primary reasons: 1) to prevent [appellant] from
12 taking Amazon with him to a new employer; and 2) to release any and all claims that he may have had
13 against DPGM.” (Resp. RHG Br., pp. 1-6.)

14 Respondent contends that under “the ‘origin of the claim’ doctrine the character of a
15 settlement payment is determined by the nature of the underlying claim” and, therefore, “[t]he taxability
16 of the settlement is controlled by the nature of the litigation.”⁷ Respondent contends that the “origin of
17 claim” doctrine was originally used to determine the character of legal expenses but the test has been
18 expanded to determine the excludability of income from taxable income. Respondent references the
19 decision in *Keller Street Development Co. v. Commissioner* (9th Cir. 1982) 688 F.2d 675 for the
20 principle that the “claim to be studied is the claim that gave rise to the transaction that created the tax
21 problem.” Respondent argues that appellants incorrectly assert that the income was attributable “to
22 intangible rights in the form of claims.” (Resp. RHG Br., pp. 6-7.)

23 Respondent restates some of the causes of action in appellant’s underlying lawsuit which
24 included claims for unpaid wages, breach of appellant’s employment contract, breach of an implied
25 covenant of good faith and fair dealing, negligent misrepresentation (asserting that DPGM did not
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27 ⁷ Respondent cites *United States v. Gilmore* (1963) 372 U.S. 39, *Gidwitz Family Trust v. Comm’r* (1974) 61 T.C. 664 citing
28 *Raytheon Production Corp. v. Comm’r* (1st Cir. 1944) 144 F.2d 110, 114 and *Keller Street Dev. Co v. Comm’r.* (9th Cir.
1982) 688 F.2d 675.

1 perform under appellant’s employment contract), conversion of unpaid and underpaid commissions and
2 unpaid kickers, fraud (with respect to misrepresentations regarding the employment contract), an
3 accounting for all commissionable payments, imposition of a constructive trust with respect to unpaid
4 amounts under the employment contract held by DPGM, retaliation for appellant’s conduct with respect
5 to the dispute over wages, and negligence per se for DPGM’s violation of its duties under the Labor Code
6 concerning payment and wages. Based on the causes of action, respondent contends that the nature of
7 the litigation was a dispute over wages and, therefore, the character of the income is compensation for
8 personal services governed by California Code of Regulations, title 18, section (Regulation) 17951-5,
9 subdivision (a)(1). (Resp. RHG Br., pp. 7-8.)

10 Respondent concludes that, although appellant moved out of California prior to the
11 settlement, appellant performed nearly all of his work in California, including the work with his most
12 significant client, Amazon. Respondent asserts that, in appellant’s complaint and in the briefing of this
13 appeal, appellants stress that the payment of commissions on the Amazon account was “the crux of
14 appellant’s dispute with DPGM.” Respondent states that the work related to the Amazon account ceased
15 in April of 2003, while appellant was still a resident of California and working in the state and cites the
16 *Appeal of Ronald P. and Gertrude B. Foltz*, 85-SBE-022, decided by the Board on April 9, 1985. (Resp.
17 RHG Br., p. 9.)

18 Respondent disputes appellants’ contention that, in the decision on the appeal, the Board
19 made “a finding that the entire settlement payments were intended to be solely as compensation for past
20 wages.” Respondent maintains that it did not argue and the Board did not find that the income from the
21 settlement was based on past wages but rather that settlement “was characterized based on the
22 underlying employment dispute as ‘income for personal services’ and those services were performed in
23 California . . .”. For that reason, respondent contends that the income was properly sourced to California.
24 Respondent further states that appellants assert in their opening brief that the two “primary reasons” for
25 the settlement payment, except for attorney fee reimbursement, were “1) to prevent Bentley from taking
26 Amazon with him to a new employer; and 2) to release any and all claims that he may have had against
27 DPGM.” (Resp. RHG Br., p. 9.)
28

1 Respondent contends that, contrary to appellants’ assertions, the Settlement Agreement
2 did not include a covenant not to compete. Rather, respondent contends that the Settlement Agreement
3 only prohibited appellant from soliciting employees or independent contractors of DPGM for one year
4 and from soliciting any customer of DPGM, with specific exceptions, for six months. Respondent notes
5 that appellant started an international and domestic freight transportation company in January 2005 and
6 he was allowed to solicit several active customers of DPGM. Respondent states that, under a covenant
7 not to compete, the covenantor agrees to refrain from competing with the covenantee for a specified
8 period of time within a particular geographic area. Respondent asserts that such a covenant is different
9 than a non-solicitation agreement which “focuses on protecting the assets (employees and customers) of
10 a party, here DPGM.” Respondent contends that, even if the non-solicitation provision were found to be
11 a non-competition agreement and the payment for that agreement was allocated by the parties, appellant
12 incorrectly places reliance on case law involving non-competition agreements made in connection with
13 the sale of a business in which such agreements are treated as intangible property and special rules for
14 sourcing are applicable. Because the Settlement Agreement arose from an employment contract rather
15 than the sale of a business, respondent contends that different sourcing rules apply. (Resp. RHG Br.,
16 p. 10.)

17 Respondent asserts that, given the circumstances under which the settlement payments
18 were received under the “alleged covenant not to compete”, the income would be sourced to California
19 as income from the performance of personal services. Respondent cites the *Appeal of Aldean and*
20 *Clara Washburn*, 82-SBE-140, decided by the Board on June 29, 1982, in which the Board “stated
21 unequivocally” that income received from a covenant not to compete is taxable as ordinary income and
22 does not constitute income from the sale of either real or personal property, or income from intangible
23 personal property, and compensation received from refraining from labor is ordinary income. (Resp.
24 RHG Br., p. 11.)

25 Respondent contends that the source of compensation received for a covenant not to
26 compete is where the promisor gave up the right to act. Respondent asserts that this rule clarifies that
27 the non-solicitation provisions did not constitute a covenant not to compete because no geographic
28 boundaries were provided and appellant was not prohibited from acting in competition with DPGM.

1 Respondent contends that appellant’s reliance on Regulation section 17951-6 and *Milhous v. Franchise*
2 *Tax Board* (2005) 131 Cal.App.4th 1360, which address the sourcing of non-competition agreements in
3 the connection with the sale of a business is misplaced.⁸ (Resp. RHG Br., p.11.)

4 Respondent contends that income from a settlement is sourced based on the underlying
5 claims and the parties did not allocate the payments in the Settlement Agreement with respect to the
6 specific promises made therein. For that reason, respondent contends that the settlement payments
7 should be sourced entirely to California based on the nature of the underlying litigation which was
8 income from personal services that were nearly all performed in California. Respondent notes that
9 DPGM issued Forms W-2 to appellant and appellant asserted in his complaint that he was at all relevant
10 times an individual employed in the state of California. Respondent also disputes appellants’ statement
11 in the rehearing opening brief that “a W-2 form is appropriate for all types of compensation payments,
12 not just past wages” and contends that the Form W-2 is used by employers to report wage and other
13 employment compensation. (Resp. RHG Br., pp.11-12.)

14 Respondent asserts that the Board “was justified in relying on the reasonable factors and
15 full justification provided by respondent” to determine that the entire amount of the settlement payments
16 was properly sourced to California. Respondent further asserts that appellants have not provided a
17 reasonable, factually-supported allocation and that appellants erroneously argue that “an allocation
18 should and must be made . . .”. Respondent contends that the ten causes of action which were resolved
19 in the Settlement Agreement were connected with appellant’s employment in California and there is no
20 need to allocate the income paid under that agreement to particular categories to then be sourced
21 individually. Respondent further contends that, even if the Board allowed appellants to present a proper,
22 factually-based allocation, such an allocation should be based on the causes of action settled or perhaps
23 to the items specified in the Settlement Agreement. In addition, respondent asserts that income from a
24 settlement agreement is sourced based on the nature of the claim and appellant did not receive income
25 from a covenant not to compete, thus no amount should be allocated to such a claim. Moreover,
26 respondent asserts that appellants are not seeking a true allocation among the causes of action settled but
27

28 ⁸ As discussed in more detail below, Regulation section 17951-6 provides the rules related to the sourcing of covenant not to
compete agreements that arise in connection with the sale of a business.

1 are seeking to “allocate” California-source income and non-California-source income. (Resp. RHG Br.,
2 pp. 12-13.)

3 Appellant’s Reply on Rehearing

4 Appellants contend that the taxability of the settlement payments is based on the purpose
5 of those payments rather than whether the dispute arose from an employment contract executed while
6 appellant was a California resident. Therefore, according to appellants, little, if any, of the payment
7 amounts was California-source income because no significant portion of the settlement was for services
8 performed or to be performed by appellant in California. Appellants also dispute respondent’s
9 contention that they have not offered a reasonable basis for an allocation. (App. RHG Reply Br.,
10 pp. 1-2.)

11 Appellants assert that respondent does not contest appellants’ statement of law that the
12 Board is required to make an allocation when an agreement is ambiguous and silent as to an allocation
13 of a settlement payment. Rather, appellants assert that respondent’s arguments that the Settlement
14 Agreement did not include a covenant not to compete and that appellants have offered no basis for
15 allocation is not supported by law or the factual record. Appellants cite *Reeves v. Hanlon* (2004) 33 Cal.
16 4th 1140 and *Dowell v. Biosense Webster, Inc.* (2009) 179 Cal.App. 4th 564, for the proposition that,
17 under California law, a covenant not to solicit a former employer’s customers is treated as a covenant
18 not to compete. Appellants further argue that Regulation 17951-6 (4) defines a covenant not to compete
19 as “any arrangement to refrain from engaging in any activity, directly or indirectly, similar to the
20 business activity carried on by the business which was sold” which includes “covenants not to solicit
21 employees, and covenants not to disclose proprietary information.” Appellants reference paragraph 13 of
22 the Settlement Agreement that defines “solicit” as including taking away the business of any customer
23 or encouraging any customer to terminate its relationship with DPGM. Appellants also reference
24 paragraph 12 which prohibits appellant from disclosing any trade secret, proprietary or confidential
25 information. (App. RHG Reply Br., pp. 2-4.)

26 Appellants argue that they have “clearly demonstrated that the parties intended a large
27 portion, if not all, of the settlement payments to be for future wages, a covenant not to compete outside
28 of California, and the release of other non-taxable rights.” Appellants point to the following as evidence:

- 1 • Appellant’s annual salary ranged from \$100,000 to \$300,000.
- 2 • The kickers in dispute for three and a half years of the Amazon account during appellant’s
- 3 employment at DPGM ranged between \$128,000 and \$200,000 per year. The future wages and
- 4 growth potential of the Amazon account were a significant reason for the dispute.
- 5 • DPGM paid appellant all outstanding wages, expenses and commissions through his separation
- 6 date pursuant to the Settlement Agreement.
- 7 • At the end of December 2004, DPGM paid appellant the first of two settlement installments for
- 8 future earnings, a covenant not to compete, non-solicitation of DPGM employees, confidentiality
- 9 agreement, appellant’s resignation, delivery of a customer list of appellants’ accounts, a
- 10 non-disparagement agreement, indemnification of DPGM for any potential California tax
- 11 liability, and a covenant not to sue DPGM in the future.

12 Appellants further assert that the Settlement Agreement “unequivocally stated” that the

13 non-solicitation provision was an “essential and fundamentally material” part, that the payment was in

14 addition to any amount appellant earned before the employment terminated and DPGM calculated that

15 \$196,765 was the most appellant was owed for the period in dispute and that DPGM overpaid him by

16 \$124,000 for that period. (App. RHG Reply Br., pp. 4-5.)

17 Appellants contend that respondent has erroneously expanded the origin of the claim

18 doctrine to support its determination that the settlement must be entirely sourced based on the

19 underlying litigation. According to appellants, the origin of the claim doctrine does not override the

20 Board’s obligation to make an allocation if the criteria established by case law cited by appellants have

21 been met. Appellants assert that the fact that the underlying claim arose from the employment

22 relationship “does not control the purpose for the payment or the applicable sourcing rules.” Appellants

23 further contend that respondent’s position is contrary to California Labor Code sections 202 and 206.5,

24 as sections 2 and 6 of the Settlement Agreement provide that all past wages were paid in full and are

25 separate from the additional settlement payments in dispute. Appellants assert that the settlement

26 payments were for future wages, a covenant not to compete, non-solicitation of DPGM employees, non-

27 disparagement and releases of all claims and were made to appellant was a resident of Washington.

28 Appellants maintain that, under Labor Code section 206.5, the releases would not have been valid if the

1 releases were required before the past wages were paid and section 2 complied with Labor Code section
2 202 by providing that appellant would be paid all outstanding past wages within 72 hours and affirming
3 that he was not entitled to additional amounts for past wages. (App. RHG Reply Br., pp. 6-8.)

4 Applicable Law

5 Respondent's determination of an assessment is presumed correct and an appellant has
6 the burden of proving it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael*
7 *E. Myers*, 2001-SBE-001, May 31, 2001.)

8 As provided in R&TC section 17041, subdivision (b), California imposes a tax upon the
9 California-source income of part-year residents and nonresidents for periods when they are nonresidents
10 and upon their income from all sources for periods when they are California residents. For purposes of
11 computing California taxable income, R&TC section 17951, and Regulation section 17951-1,
12 subdivision (a), provide that the gross income of nonresidents includes only their gross income from
13 sources within California.

14 What constitutes a reasonable apportionment method so as to properly limit a taxpayer's
15 gross income to that earned "from sources within this State" pursuant to R&TC section 17951 must be
16 based upon the facts and circumstances of each case. (*Appeal of James B. and Linda Pesiri*,
17 89-SBE-027, Sept. 26, 1989.) In that appeal, nonresident taxpayers sold their California business and
18 entered into a personal covenant not to compete as part of the transaction. Taxpayers argued that the
19 covenant was an intangible and not taxable by California since it did not acquire a tax situs in California.
20 The Board rejected this argument, holding that after limiting the geographic area of the covenant to the
21 place where the business was located, and utilizing the California sales numbers of the business, an
22 allocation of 25 percent of the income related to the covenant not to compete could be sourced to
23 California. In the *Appeal of Aldean and Clara Washburn, supra*, the Board determined that income from
24 covenants not to compete is sourced to the place where the taxpayer promised not to compete (in that
25 appeal, a location in California) in order to determine the source of the income.

26 In *Reeves v. Hanlon*, the court held that under California case and statutory law reflect a
27 long-held public policy that "[a] former employee has the right to engage in a competitive business for
28 himself and to enter into competition with his former employer, even for the business of . . . his former

1 employer, provided such competition is fairly and legally conducted.” (Quoting *Continental Car-Na-Var*
2 *Corp. v. Moseley* (1944) 24 Cal.2d 104, 110 and citing Bus. & Prof. Code, § 16600.) In *Dowell v.*
3 *Biosense Webster, Inc.* the court held that a “broadly worded non-compete clause” and a separate
4 “broadly worded non-solicitation clause” in an employment agreement were void and unenforceable
5 under B&P Code section 16600. (*Dowell, supra* at 575.)

6 Regulation section 17951-2 provides that income from sources within California includes
7 compensation for personal services performed in California. (See *Appeal of Robert C. and Marian*
8 *Thomas*, 55-SBE-006, Apr. 20, 1955.) The critical factor that determines the source of income from
9 personal services is not the residence of the taxpayer, the place where the contract for services was
10 executed, or the place of payment, but rather the place where the services are performed. (*Appeal of*
11 *Sam and Betty Spiegel*, 86-SBE-121, June 10, 1986.)

12 Regulation section 17951-6 provides specific guidance on how to assign income to
13 California for a covenant not to compete “executed in connection with the sale of business conducted
14 entirely within California or within and without California . . .” (Cal. Code Regs., tit. 18, § 17951-6,
15 subd. (a).) The regulation provides that the first step is to identify the legally enforceable area where the
16 promisor has forfeited the right to act. Income is then assigned to the identified legally enforceable area
17 using the property, payroll and sales apportionment factors of the business that was sold. (Regs., tit. 18,
18 §§ 17951-6, subd. (a)(1) and subd. (a)(2).) *Milhous v. Franchise Tax Bd.* (2005) 131 Cal.App.4th 1360,
19 involved nonresident taxpayers who never conducted businesses in California, but rather gave up the
20 right to conduct business in California through a covenant not to compete associated with the sale of a
21 business. The court held that California could not tax the value of the covenant because no part of the
22 covenant payments arose from activities in California or from capital located in California. (*Milhous*,
23 *supra*, at p. 1269.)

24 R&TC section 17952 provides that income from intangibles to a nonresident is not
25 California source income, unless the intangible has acquired a business situs in this state. If intangible
26 personal property of a nonresident has acquired a business situs in California, then the entire income
27 from the property, including gains from the sale of the property, regardless of where the sale is
28 consummated, is income from sources within California and is taxable to the nonresident. (Cal. Code

1 Regs., tit. 18, § 17952, subd. (c).)

2 Courts often look to the origin or nature of the claim in the underlying suit to determine
3 the tax consequences of an award. (See *U.S. v. Gilmore*, *supra*, 372 U.S. 39; *Woodward v. Comm’r*,
4 (1970) 397 U.S. 572, 578; *Keller St. Dev. Co. v. Comm’r*, *supra*, 688 F.2d 675, 678 - 680.) The doctrine
5 originated in *U.S. v. Gilmore* which involved the deductibility of legal fees incurred in a divorce action.
6 The *Gilmore* court determined that the husband’s legal fees could not be deducted as a business expense,
7 even though his goal when incurring those fees was to protect his corporations from community
8 property claims of his wife. The court found the underlying claims stemmed entirely from the marital
9 relationship rather than the income-producing activity, and the husband was not allowed to classify the
10 legal expenses as a business expense. (*U.S. v. Gilmore*, *supra*.) In *Keller Street Development Co.*,
11 *supra*, the court explained that characterizing a transaction for tax purposes is a two-step process
12 whereby the initial step is discovering the origin of the claim from which the tax dispute arose and, thus,
13 “the second step, the actual tax characterization is dependent upon the resolution of the preliminary
14 attribution.” (*Keller St. Dev. Co.*, *supra* at 679.)

15 The determination of the taxable consequences of a settlement payment is a factual
16 inquiry of what the agreement settled. (*Stocks v. Comm’r* (1992) 98 T.C. 1, 10.) To determine the tax
17 consequences of an award or settlement agreement, courts often analyze the payment from the
18 perspective of the payor. (See *Fono v. Comm’r*, *supra*, 79 T.C. 680 (affd. 749 F.2d 37 (9th Cir. 1984),
19 and *Knuckles v. Comm’r*, *supra*, 349 F.2d 610.) If the settlement agreement lacks express language
20 stating what the amount was paid to settle, then the most important factor in determining the tax
21 consequences of the agreement is to examine the intent of the payor regarding the purpose in making the
22 payment. (*Stocks v. Comm’r*, *supra*.)

23 STAFF COMMENTS

24 Appellants maintain that the provision of the Settlement Agreement under which
25 appellant agreed not to recruit employees or independent contractors of DPGM for one year and not to
26 solicit DPGM customers for six months, excluding appellant’s five major clients, constituted a covenant
27 not to compete. As support for that interpretation, appellants cite *Reeves v. Hanlon*, *supra* and *Dowell v.*
28 *Biosense Webster, Inc.*, *supra*, but in the view of the Appeals Division neither of those cases decided the

1 issue of whether, under California law, a covenant not to solicit a former employer’s customers or
2 employees constitutes a covenant not to compete. *Reeves v. Hanlon* involved the issue of whether an
3 attorney who left a law firm was liable for several torts, including intentional interference with
4 contractual relationships and interference with prospective business opportunity, as a result of
5 persuading his former law firm’s employees to join another firm, soliciting clients to leave the former
6 firm and hire his new firm, misappropriating trade secrets, destroying computer files and data, and
7 withholding the former firm’s property. In *Dowell v. Biosense Webster, Inc., supra*, two individuals left
8 their employment and went to work for their former employer’s competitor notwithstanding separate
9 non-solicitation and non-competition clauses in their employment agreements with the former employer.
10 Appellants also cite Regulation 17951-6(4) which provides for the sourcing of income from “a covenant
11 not to compete executed in connection with the sale of a business. . .” However, the Settlement
12 Agreement did not involve the sale of a business but resolved litigation over unpaid wages, breaches of a
13 written contract and implied covenant of good faith and fair dealing, negligent misrepresentation,
14 conversion, fraud, accounting, and constructive trust. At the hearing, appellants should be prepared to
15 present any other legal authority to support their position that the non-solicitation provisions of the
16 Settlement Agreement constituted a covenant not to compete and that the settlement payments were
17 made in exchange for that covenant. In addition, respondent should be prepared to discuss and cite any
18 case law authority for its position that a covenant not to compete is distinguishable from a
19 non-solicitation agreement for purposes of sourcing income arising from that agreement.

20 As legal authority for California-sourcing of the settlement payments, respondent cites
21 *Keller Street Development Co.* for its position that the “origin of the claim” doctrine under which “the
22 character of a settlement payment is determined by the nature of the underlying claim” dictates that
23 “[t]he taxability of the settlement is controlled by the nature of the litigation.” However, in that case, the
24 court determined that a settlement payment was properly characterized for tax purposes as ordinary
25 income rather than capital gain and did not involve an issue of proper sourcing of the payment. At the
26 hearing, respondent should be prepared to discuss the origin of the claim doctrine (and provide any
27 supporting case law) as it relates to characterizing income for sourcing purposes.

28 It appears to staff that the language in the Settlement Agreement stating that the parties

1 agree as an “essential and fundamentally material part of the Agreement that [appellant] will be bound
2 by the nonsolicitation provisions” may have been intended to ensure that the nonsolicitation provision
3 was enforced and not separately challenged or severed from the agreement. The parties should be
4 prepared to discuss whether the language suggests that the primary purpose of the settlement payments
5 was to obtain the nonsolicitation agreement, or, alternatively, whether the language suggests that the
6 nonsolicitation provision was an inextricable part of a settlement to resolve litigation that arose from
7 compensation for services performed in California.

8 If the Board determines that it is appropriate to allocate income from settlement of the
9 litigation claims and the non-solicitation provision, appellant should be prepared to provide evidence
10 demonstrating how much income should be allocated to the non-solicitation provision.

11 Pursuant to California Code of Regulations, title 18, section 5523.6, if either party has
12 any additional evidence to present, it should be provided to the Board’s Board Proceedings Division at
13 least 14 days prior to the oral hearing.⁹

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⁹ Exhibits should be sent to: Khaaliq Abd’allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.