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

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
 11) **PERSONAL INCOME TAX APPEAL**
 12 **WALTER B. ELCOCK AND**) Case No. 474172
 13 **LAURA K. ELCOCK¹**)
 14 _____)

	<u>Years</u>	<u>Claim for Refund</u>	<u>Penalty</u>
	2003	\$87,209.00	\$21,802.25
	2004	\$15,282.00	\$3,820.50
	2005	\$28,585.00	
	2006	\$89,822.00	

19 Representing the Parties:

20 For Appellants: William E. Taggart, Jr., Attorney
 21 For Franchise Tax Board: Jeanne M. Sibert, Tax Counsel III
 22

23 **QUESTIONS:** (1) Whether respondent's allocation methodology to source California income from
 24 the exercise of nonqualified stock options (NQSO(s)) received from appellant-
 25 husband's employer was proper.

26 (2) Whether respondent's allocation methodology to source California income from
 27

28 ¹ Appellants reside in Dallas, Texas.

1 the vesting of restricted stock grants received from appellant-husband's employer
2 was proper.

3 (3) Whether appellants have shown reasonable cause to support the abatement of late
4 filing penalties for 2003 or 2004.

5 HEARING SUMMARY

6 Background

7 Appellant-husband was employed by NationsBank Corporation and later BankAmerica
8 Corporation (BAC) from 1974 through the tax years at issue. BAC transferred appellant-husband to
9 California on September 1, 1998, with appellants becoming California residents on that date. As an
10 employee of BAC (and its predecessor), appellant-husband was awarded restricted stock grants when he
11 was a California resident (on January 3, 2000) and separate grants of NQSOs when he was a California
12 nonresident (prior to September 1, 1998) and when he was a California resident (after September 1,
13 1998). Appellant-husband subsequently moved to Texas and was no longer a California resident after
14 December 17, 2001; appellant-wife moved to Texas and was no longer a California resident after
15 April 10, 2002. Thus for the tax years at issue, appellants were California nonresidents.

16 For the income recognized upon the exercise of NQSOs during the relevant tax years,
17 respondent treated the NQSO income as compensation income and treated a portion of such income as
18 California source income. To allocate the amount of NQSO income that should be treated as California
19 source income, respondent multiplied the entire compensation income recognized upon the exercise of
20 the NQSOs against a calendar day formula (hereafter, calendar formula). The calendar formula was a
21 ratio of the number of calendar days appellant-husband spent within and without California over the
22 total calendar days calculated from the grant date to the exercise date. This can be represented as
23 follows:

$$24 \quad \frac{\text{Calendar days in California}}{\text{Total calendar days}} \quad X \quad (\text{Income upon exercise of NQSOs})$$

25
26 A similar calendar formula was used for calculating the California source income on the restricted stock
27 but using the total days within and without California from the grant date to the vesting date (as opposed
28 ///

1 to the exercise date) of the restricted stock.² As for the late filing penalties, respondent contends that
2 appellants did not timely file California income tax returns for 2003 and 2004, so the late filing penalties
3 were imposed for those years.

4 On August 4, 2006, respondent issued a determination letter to appellants concluding that
5 appellants had California source income based on the calendar formula. In response to this letter, on
6 August 29, 2006, appellants requested respondent to issue a Notice of Proposed Assessment (NPA) for
7 2003 and 2004. On September 5, 2006, appellants paid \$122,374.17 for the 2003 tax year. On
8 November 27, 2006, respondent issued an NPA for 2003 that increased appellants' California taxable
9 income to \$951,030 and proposed an assessment of \$87,209. This NPA also proposed to assess a late
10 filing penalty of \$21,802.25. On November 15, 2007, appellants filed a 2003 Form 540X showing a
11 refund of \$87,209.

12 Respondent issued a determination letter for 2004 on August 4, 2006, showing California
13 source income of \$204,387.00, with proposed income tax of \$15,282.00 and a proposed late filing
14 penalty of \$3,820.50. For the 2004 tax year appellants paid \$20,555 on September 5, 2006. On
15 November 27, 2006, respondent issued an NPA for 2004 increasing appellants' California taxable
16 income to \$172,683.00, proposing an assessment of California tax of \$15,282.00, and imposing a late
17 filing penalty of \$3,820.50. On November 15, 2007, appellants filed a Form 540X seeking a refund of
18 the previously paid \$15,282 in tax.

19 On September 6, 2006, appellants filed a 2005 California Nonresident or Part-Year
20 Resident Income Tax Return (Form 540NR) and reported and paid \$28,585 in tax. On December 20,
21 2007, appellants filed a 2005 Form 540X seeking a refund of the \$28,585 previously paid.

22 On October 1, 2007, appellants timely filed a 2006 Form 540NR and reported and
23 apparently paid tax of \$89,822. On January 8, 2008, appellants filed an amended return for 2006 (Form
24 540X) seeking a refund of the \$89,822 previously paid.

25 Respondent denied appellants' refund claims for all of the tax years at issue on July 28,
26

27 ² For clarity purposes, "allocation period" in this summary will refer to the per diem ratio period used to allocate income from
28 either NQSOs or restricted stock under any one of the various possible periods (*e.g.*, grant to exercise date, grant to vesting
date, etc.).

1 2008. This timely appeal followed.

2 Contentions

3 Appellants' Contentions

4 Appellants contend that the relevant facts of this appeal are not in dispute, which are
5 summarized in respondent's July 28, 2008 refund denial letter (Denial Letter). Pursuant to the Denial
6 Letter, appellants were living in Texas throughout the tax years at issue and were California
7 nonresidents. (App. Opening Br. at 2-3). Appellants claim the following amounts of income were
8 recognized for the relevant tax years:

	<u>Years</u>	<u>NQSOs</u>	<u>Restricted Stock</u>
9	2003	\$1,143,438.00 ³	\$93,981.00 ⁴
10	2004	\$530,975.00 ⁵	N/A
11	2005	\$897,200.00 ⁶	N/A
12	2006	\$3,052,965.70 ⁷	N/A

13 Appellants contend that no portion of this income was California source income and
14 taxable by California. Appellants claim that the two issues in this case are solely questions of law: (1)
15 what should be the proper methodology for sourcing NQSOs income to California; and (2) what should
16 be the proper methodology for sourcing restricted stock income to California.

17 Appellants also claim that they are in basic agreement with respondent on the basic
18 taxation issues with regards to NQSOs (App. Opening Br. at 8), but that the disagreement with respect to
19 NQSOs and restricted stock is how such income should be sourced to California, when a portion of such
20 income may have been earned in California. (App. Opening Brief at 6.)

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23 _____
24 ³ Respondent contends that appellant-husband's Form W-2 for 2003 showed \$2,239,541.18 in NQSO income.

25 ⁴ Respondent appears to agree with this amount.

26 ⁵ Respondent conceded that this was the amount of taxable gain from the NQSOs for this year, but stated that appellant-
27 husband's 2004 Form W-2 showed taxable compensation of \$558,523.22 from the exercise of NQSOs.

28 ⁶ Respondent stated that this amount is consistent with appellant-husband's 2005 Form W-2.

⁷ Respondent stated that this amount is consistent with appellant-husband's 2006 Form W-2.

1 *Appellants' View of the Multi-year Calendar Formula*

2 Appellants contend there is no statutory or case law authority for the FTB's adoption of
3 the grant to exercise rule in the context of NQSOs. (App. Opening Br. at 8.) Appellants contend that
4 FTB Publication 1004, Stock Option Guidelines (hereafter, Publication 1004) provides California tax
5 guidelines for the taxation of the gains from the exercise of stock options by residents and nonresidents.
6 (App. Add'l Brief, at 3) Appellants state that Publication 1004 does not extend to the treatment of
7 restricted stock, but that the calendar formula used "for the determination of sourcing income from the
8 payment of compensation income in the form of intangible personal property" is an underground
9 regulation.⁸ Appellants claim the plain language of Revenue and Taxation Code (R&TC) section 17951
10 and one of the regulations promulgated thereunder, California Code of Regulations, title 18, (CCR)
11 section 17951-5, subdivision (b) (hereafter Subdivision (b)) limit their application to a single year.
12 Appellants claim the calendar formula involves multi-year formulas which do not appear to be
13 contemplated by R&TC section 17951 and Subdivision (b). Appellants claim that the definition of a
14 regulation under the California Administrative Procedures Act (APA) beginning in Government Code
15 (GC) section 11340 is very broad, embracing "'every rule, regulation, order, or standard of general
16 application or the amendment, supplement, or revision of any rule, regulation, order, or standard adopted
17 by any state agency to implement, interpret, or make specific law enforced or administered by it, or to
18 government its procedure.' (Gov. § 11342.600)" (App. Add'l Br. at 4-5.)

19 Appellants further claim that *Tidewater Marine Western, Inc. v. Bradshaw* (1996) 14 Cal.
20 4th 557, provides that there are two principal characteristics that identify a regulation for purposes of the
21 APA. First the agency must intend that a rule generally apply, rather than apply to a specific case.
22 Second, the rule must implement, interpret, or make specific law enforced or administered by the
23 agency. Appellant contends that the calendar formula at issue is not being used by respondent in an "ad
24

25
26 ⁸ Board staff notes that Publication 1004 utilizes a workday formula (focusing on workdays rather than calendar days) for
27 purposes of allocating income from NQSOs and other options. Publication 1004 does not address the allocation of income
28 from restrictive stock. Respondent states that it utilized total calendar days in this case because during examination, it
determined that when appellant-husband was a California resident, all of his work was substantially performed within
California. (Resp. Add'l Br. at 7.) It appears that, compared to the workday formula, a calendar formula (which includes all
the weekend days outside of California), may be more favorable to a taxpayer if the total number of days (the denominator)
includes a substantial number of weekend days outside of California.

1 hoc" manner, is not supported by Subdivision (b), and should be held invalid under GC section 11340.5
2 and given no deference under the two-prong rule advanced in *Tidewater*.

3 *Appellants' NQSOs Arguments*

4 For NQSOs, appellants agree with respondent's approach that NQSOs are taxable upon
5 exercise; appellants however believe there is no statutory or case law authority for respondent's
6 allocation methodology, *i.e.*, the calendar formula for NQSOs. Appellants state that the *Appeal of*
7 *Charles W. and Mary D. Perelle*, 58-SBE-057, Dec. 17, 1958, does not support respondent's calendar
8 formula. Appellants believe that any allocation formula should satisfy two basic principles: (1)
9 consistency with the principles for taxing NQSOs; and (2) administrative ease of applicability. (App.
10 Opening Br. at 10.) Appellants assert that the calendar formula is the least reasonable under these two
11 principles. (*Id.*) Instead, appellants offer three rules which they contend are better alternatives to
12 respondent's calendar formula.

- 13 1. Year of Grant Rule: (a calendar formula using an allocation period limited to the days within and
14 without California for the single year in which the NQSOs were granted);
- 15 2. Period of Vesting Rule: (a calendar formula using an allocation period limited to the days within
16 and without California from the grant date to the date of vesting);
- 17 3. Year of Exercise Rule: (a calendar formula using an allocation period limited to the days within
18 and without California for the single year in which the NQSOs were exercised).⁹

19 Appellants stated that respondent's calendar formula is not reasonable because the
20 employee may no longer be employed by the employer that granted the NQSO when the NQSO is
21 finally exercised.¹⁰ Appellants believe the Year of Grant Rule and the Period of Vesting Rule are more
22 in line with the concept of NQSO employee compensation, as the employee is still employed by the
23 grantor employer at those times. However, appellants favor the Year of Exercise Rule for NQSOs as the
24 most appropriate rule (using only days within/without California for the year of exercise), but concede
25 that the Period of Vesting Rule is a close second. (App. Opening Br. at 12.) Appellants contend that
26

27 ⁹ See App. Opn. Brief, p. 10, last paragraph.

28 ¹⁰ This appears to Board staff to be a hypothetical argument, as appellant-husband was employed by the grantor of the
NQSOs for the tax years at issue.

1 from the standpoint of effective tax administration, the Year of Exercise Rule for NQSOs is the most
2 appropriate, as it is the year in which a Form W-2 is provided to the employee. (App. Opening Br. at
3 11.) Appellants believe respondent's calendar formula allocation period (using total days from the grant
4 date to exercise date) is the least reasonable of the possible methods and is therefore arbitrary and
5 capricious. (App. Opening Br. at 12.)

6 *Appellants' Restricted Stock Contentions*

7 Appellants believe there are three possible allocation rules for restricted stock:

- 8 1. Year of Grant Rule: (a calendar formula using an allocation period limited to the days within and
9 without California for the single year in which the restricted stock was granted);
- 10 2. Period of Vesting Rule (with the allocation period modified from grant date to vesting date).
- 11 3. Single-Year Vesting Rule (a calendar formula with an allocation period limited to the days
12 within and without California for the single year of vesting).¹¹ (App. Opening Brief at 12-13.)

13 Appellants believe the difference between the recognition event for compensatory
14 restrictive stock (upon vesting) versus the recognition event for compensatory NQSOs (upon exercise)
15 warrants a different allocation formula for restricted stock. For restrictive stock, appellants contend the
16 period of services are more closely aligned with the period of vesting. Thus, for restricted stock
17 appellants believe the Single-Year Vesting Rule is the best rule and that respondent's failure to adopt
18 this rule is arbitrary and capricious. (App. Opening Br. at 13.)

19 Appellants also ask whether the rule proposed by FTB for the sourcing of NQSOs "will
20 be sustained if challenged under the United States Constitution." (App. Optional Supp. Reply Br. at 5.)

21 Respondent's Contentions

22 Respondent contends that income to employees from NQSO and restricted stock granted
23 by their employers constitutes compensation income, which is governed under Internal Revenue Code
24 (IRC) section 83(a). (Resp. Opening Br. at 9.) Pursuant to this section, NQSO income is taxable upon
25 exercise. Respondent contends that income from services provided in California constitutes California
26

27 ¹¹ Note that appellants' Single-Year Vesting Rule allocation period for restricted stock only looks to the days within the single
28 year of vesting. This approach is different from appellants' Period of Vesting Rule for NQSOs, which used an allocation
period that included all days from the grant date to the vesting date.

1 source income under R&TC section 17041. Respondent, relying on *Appeal of James B. and Linda*
2 *Pesiri*, 89-SBE-153, Sept. 26, 1989, contends that its allocation formula must be based on the facts and
3 circumstances of each case. Respondent further contends that the calendar formula is authorized by
4 Subdivision (b), which allows allocation of income that reasonably attributes personal services
5 performed in California. (Resp. Opening Br. at 13.) Respondent contends that its calendar formula is
6 neither arbitrary nor capricious. Respondent contends that appellants' suggested alternative for NQSOs
7 is disconnected from the time period the income is earned (*i.e.*, grant date to exercise date). Respondent
8 also contends that income from the exercise of NQSOs should reflect where services were performed
9 during the life of the option, not just the year the NQSOs were exercised. In this case, respondent claims
10 that appellants' Year of Exercise Rule would result in no income being sourced to California, even
11 though appellant performed services in California for nearly two years for several of the groups of
12 NQSOs and over three years of services in California for the remaining groups of NQSOs. (Resp. Add'l
13 Br. at 10-12.) Thus, respondent contends that its calendar formula more reasonably allocates the income
14 earned from NQSOs and that appellants' Year of Exercise Rule is unreasonable.

15 As for the restricted stock, respondent argues that such income is taxable on the vesting
16 date and that the calendar formula (using grant date to vesting date) more reasonably allocates the
17 income that is earned (from grant date to vesting date) to the states where employment services were
18 provided during this period. Respondent submits that appellants' suggested alternative approaches
19 ignore the total compensation period and overly focus on the single year income is recognized (single-
20 year vesting rule) or on the single year the compensation period began (year of grant rule). Respondent
21 contends that under appellants' Single Year Vesting Rule, since the restricted stock vested on January 3,
22 2003, appellants are suggesting a three-day total allocation period (*i.e.*, January 1, 2003 through
23 January 3, 2003). Respondent contends that this would result in no income sourced to California (since
24 appellants were nonresidents in 2003), even though appellant-husband had 715 days in California
25 between the grant and vest date of the restricted stock. Thus, respondent claims appellants' approach for
26 allocating restricted stock would not accurately reflect the fact that appellant-husband performed
27 services in California during the two of the three years between the grant and vest of the restricted stock.
28 (Resp. Add'l Br. at 13.)

1 *Respondent's Response to Appellants' Underground Regulation Contention*

2 Respondent contends that its use of Publication 1004 and its rule with respect to
3 determining California source income for NQSOs does not constitute an underground regulation. (Resp.
4 Add'l Br. at 3.) Respondent contends that its grant date to exercise date represents "a reasonable method
5 based on the facts and circumstances of this appeal." (Resp. Opening Br. at 11 and footnote 40.)
6 Respondent contends that there is no statutory or regulatory authority for the Board to determine
7 whether Publication 1004 is an underground regulation and that this publication simply reflects the law
8 as described in R&TC sections 17041, 17951, 17954, and CCR sections 17951-1, -2, and -5. (*Id.*)
9 Moreover, respondent states that there is no evidence that Subdivision (b) is anything but a properly
10 promulgated regulation and that the authority to invalidate a California regulation rests with the
11 California Office of Administrative Law, the Governor's Office or the courts. (Resp. Add'l Br. at 4.)
12 Respondent argues that the Board has authority to find for or against a specific taxpayer in the context of
13 a particular appeal, citing R&TC section 19047.

14 With respect to the application of Subdivision (b), respondent contends that it is not
15 limited to interval workers, but that its purpose is to determine a nonresident's California source income
16 from compensation for the performance of services in California. (Resp. Add'l Br. at 4.) Respondent
17 claims Subdivision (b) simply reflects what the statutes require, nonresidents are only taxed on their
18 California source income, the source of the compensation is based upon where the taxpayer performed
19 the services, if the taxpayer performed services in California, then a portion of the compensation is
20 California source income. (*Id.*)

21 Respondent contends that even if Publication 1004 is completely disregarded, the statutes
22 and regulations referred to above still exist and have independent force and effect. Moreover,
23 respondent contends that "the use of a certain allocation formula to allocate to California that portion of
24 appellant-husband's total compensation which is reasonably attributable to personal services performed
25 in California, as provided by Regulation section 17951-5" is not an underground regulation. (*Id.*)
26 Respondent contends that Subdivision (b) does not mandate one type of method; rather, it requires that
27 the determination of a nonresident taxpayer's California source income be an amount which is
28 reasonably attributable to personal services in California.

1 Respondent contends that in the *Appeal of Sam and Betty Spiegel* (86-SBE-121), decided
2 June 10, 1986, the Board sanctioned the use of the calendar formula to allocate compensation-based
3 income over a multi-year (i.e., 1975 and 1976) period, stating that the methodology in that case
4 constituted a "reasonable allocation" of compensation income.

5 Respondent contends where it has applied a formula to allocate income (such as the
6 calendar formula), the taxpayer bears the burden of showing that the application is intrinsically arbitrary
7 or that it produced an unreasonable result. (*Appeal of Melvin A. and Adele R. Gustafson*, 88-SBE-027,
8 Nov. 29, 1988.)

9 As for appellants' constitutional claims of discrimination or double taxation, respondent
10 states that the Board cannot determine that a statutory provision is unconstitutional, because section 3.5
11 of Article III of the California Constitution prevents the Board from determining that the statutory
12 provisions are unconstitutional or unenforceable. (Citing *Appeal of Aimor Corp.*, 83-SBE-221, Oct. 26,
13 1983.)

14 Finally, respondent contends that since appellants failed to file income tax returns by the
15 applicable due dates in 2003 and 2004, they were properly subject to the late filing penalty under R&TC
16 section 19131.

17 Applicable Law

18 Burden of Proof

19 Respondent's determination of an assessment is presumed correct, and the taxpayer has
20 the burden of proving it to be wrong. (*See Todd v. McColgan* (1949) 89 Cal.App.2d 509; in which the
21 court found that respondent's method for determining the portion of income attributable to the taxpayer's
22 separate (as opposed to community) capital was proper.) The court found there that "[th]e taxpayer
23 cannot merely assert the incorrectness of a determination of a tax or the method used and thereby shift
24 the burden to the commissioner to justify the tax and the correctness thereof. It is the well-established
25 rule that when the plan of allocation [in *Todd*, a community/separate property allocation formula] is
26 found to be reasonable and rational the burden of showing error in defendant's computation or
27 application is upon the taxpayer." (*Id.* at 514.)

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1 NQSO's and Restricted Stock Compensation

2 The taxation of NQSOs and restricted stock compensation is governed by IRC section 83
3 (as incorporated by R&TC section 17081), and the Treasury Regulations promulgated thereunder, which
4 provide that a taxpayer does not recognize any gain when NQSOs are granted, but that the taxpayer
5 recognizes taxable compensation to the extent the fair market value of the stock exceeds the option price
6 upon exercise.¹² As for restricted stock, gain is recognized upon vesting.¹³

7 "When assets are transferred by an employer to an employee to secure better services
8 they are plainly compensation. It makes no difference that the compensation is paid in stock rather than
9 in money." (*Comm'r v. LoBue* (1956) 351 U.S. 243, 247.)

10 Allocating California Source Income

11 Personal services performed in California give rise to California source income. (*Appeal*
12 *of Robert C. and Marian Thomas*, 55-SBE-006, April 20, 1955.)

13 R&TC section 17041 provides that the California taxable income of a California
14 nonresident includes gross income and deductions derived from California sources. R&TC section
15 17951 provides that for nonresident taxpayers, gross income includes only the gross income from
16 sources within California. R&TC section 17954 provides that for purposes of computing "taxable
17 income of a nonresident or part-year resident under paragraph (1) of subdivision (i) of Section
18 17041...gross income from sources within and without this state shall be allocated and apportioned
19 under rules and regulations prescribed by the Franchise Tax Board."

20 CCR section 17951-1, subdivision (a) provides that nonresidents are taxable only upon
21 taxable income derived from sources within this state.

22 CCR section 17951-2 provides that "[i]ncome from sources within this State includes . . .
23 compensation from personal services performed within this State (see Reg. 17951-5)"

24 CCR section 17951-5 provides as follows:

25 Wages, Salaries and Other Compensation for Personal Services Performed in This State
26

27 ¹² See Treas. Reg. § 1.83-7. .

28 ¹³ Both parties agree with this application of IRC section 83 to the NQSOs and restricted stock.

1 (a) (1) The gross income from commissions earned by a nonresident traveling salesman,
2 agent or other employee for services performed or sales made whose compensation
3 depends directly on the volume of business transacted by him, includes that proportion of
4 the compensation received which the volume of business transacted by such employee
5 within the State of California bears to the total volume of business transacted by him
6 within and without the State.

7 (2) Nonresident actors, singers, performers, entertainers, wrestlers, boxers, etc., must
8 include in gross income as income from sources within this State the gross amount
9 received for performances in this State.

10 (3) Nonresident attorneys, physicians, accountants, engineers, etc., even though not
11 regularly engaged in carrying on their professions in this State, must include in gross
12 income as income from sources within this State the entire amount of fees or
13 compensation for services performed in this State on behalf of their clients.

14 (4) If nonresident employees (including officers of corporations, but excluding
15 employees, mentioned in (1) above) are employed continuously in this State for a definite
16 portion of any taxable year, the gross income of the employees from sources within this
17 State includes the total compensation for the period employed in this State.

18 (b) If nonresident employees are employed in this State at intervals throughout the
19 year, as would be the case if employed in operating trains, boats, planes, motor buses,
20 trucks, etc., between this State and other states and foreign countries, and are paid on a
21 daily, weekly or monthly basis, the gross income from sources within this State includes
22 that portion of the total compensation for personal services which the total number of
23 working days employed within the State bears to the total number of working days both
24 within and without the State. If the employees are paid on a mileage basis, the gross
25 income from sources within this State includes that portion of the total compensation for
26 personal services which the number of miles traversed in California bears to the total
27 number of miles traversed within and without the State. If the employees are paid on
28 some other basis, the total compensation for personal services must be apportioned
between this State and other States and foreign countries in such a manner as to allocate
to California that portion of the total compensation which is reasonably attributable to
personal services performed in this State. Gross income from sources within this State
does not include qualified retirement income, as defined in Section 17952.5 of the
Revenue and Taxation Code received by a nonresident during a taxable year beginning
on or after January 1, 1996.

29 Except for the later introduction of the last sentence, the language of CCR section
30 17951-5 is nearly identical to the language of the regulation as it existed in 1937. (Personal
31 Income Tax Regulations (1937) Article 7(f)-5.) However, there are some differences in
32 numbering. Current subdivisions (a)(1), (a)(2), (a)(3), and (a)(4)¹⁴ were previously identified as
33 separate subdivisions (a), (b), (c), and (d), respectively. The language of the current Subdivision
34 (b) did not have its own separate subdivision, but was included as a paragraph under former

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36 ¹⁴ Hereafter, all references to these specific subdivisions (i.e., (a)(1), (a)(2), etc.) will be to the subdivisions of CCR section
37 17951-5, unless otherwise indicated.

1 subdivision (d) as follows:

2 (d) If nonresident employees (including officers of corporations, but excluding
3 employees, mentioned in (a) above) are employed continuously in this State for a definite
4 portion of any taxable year, the gross income of the employees from sources within this
5 State includes the total compensation for the period employed in this State.

6 If nonresident employees are employed in this State at intervals throughout the year,
7 as would be the case if employed in operating trains, boats, planes, motor buses, trucks,
8 etc., between this State and other states and foreign countries, and are paid on a daily,
9 weekly or monthly basis, the gross income from sources within this State includes that
10 portion of the total compensation for personal services which the total number of working
11 days employed within the State bears to the total number of working days both within
12 and without the State. If the employees are paid on a mileage basis, the gross income
13 from sources within this State includes that portion of the total compensation for personal
14 services which the number of miles traversed in California bears to the total number of
15 miles traversed within and without the State. If the employees are paid on some other
16 basis, the total compensation for personal services must be apportioned between this
17 State and other States and foreign countries in such a manner as to allocate to California
18 that portion of the total compensation which is reasonably attributable to personal
19 services performed in this State.

20 (Personal Income Tax Regulations (1937) Article 7(f)-5.)¹⁵

21 In *Newman v. Franchise Tax Bd.*, (1989) 208 Cal. App. 3d 972, the California
22 court of appeal relied on R&TC section 17954 and Subdivision (b) to establish an allocation
23 formula that divided an actor's income from a film contract for days spent within and without
24 California in 1973 during a total contract period of 54 days to establish how much income should
25 be reported when income from the movie in later years was received (at issue in the case was the
26 1975 tax year). The actor was coming in and out of California during the contract period and
27 was on call for possible filming days. The court of appeal determined this allocation approach
28 was consistent with respondent's duty day approach with athletes.

In *Appeal of Melvin A. and Adele R. Gustafson*, 88-SBE-027, Nov. 29, 1988, the Board
stated that allocating the taxpayer's income from meat packing employment services was a "complicated
question." The taxpayer argued that he spent a minimal amount of time performing his Nebraska
services in California (15-30 minutes by phone from California three times per week, plus two weeks
presence in Nebraska). On a strict time-based approach this equaled approximately 51.6 percent
Nebraska time (i.e., 80 hours Nebraska time to 75 California hours (90 minutes per week times 50

¹⁵ The complete regulation and original text of Subdivision (b), set forth in former subdivision (d), is reproduced here to perhaps shed some light on the original (and current) purpose/intent of Subdivision (b).

1 weeks)). Respondent originally relied solely on the three-week presence in Nebraska and deemed the
2 California personal services rendered constituted 94.23 percent of the taxpayer's services (apparently
3 49weeks/52weeks).¹⁶

4 Respondent later concluded that the taxpayer should be deemed to have worked in
5 California for the Nebraska corporation for the same portion of the total year as the Nebraska
6 corporation income bore to the taxpayer's total income (declining to use the strictly time-based method),
7 contending that the taxpayer was compensated for his availability for consultations, not on a per minute
8 basis. On these facts, the Board stated that "where the respondent has applied a formula for allocation of
9 income, the taxpayer bears the burden of showing that the application is intrinsically arbitrary or that it
10 produced an unreasonable result."¹⁷ The Board cited *Appeal of Union Carbide and Carbon Corp*, 57-
11 SBE-018, Aug. 19, 1957. In that decision, the Board reviewed whether the corporate taxpayer was
12 unitary with several subsidiaries and after concluding it was, the Board went on to state that "[o]nce it
13 has been determined that a business is unitary the taxpayer can prevail on the constitutional argument
14 only by showing that the allocation formula is intrinsically arbitrary or that it has produced an
15 unreasonable result."¹⁸

16 In *Appeal of Sam and Betty Spiegel, supra*, the taxpayer was a nonresident motion picture
17 producer who began developing a movie concept in May 1973. On May 15, 1975, the taxpayer entered
18 into a contract to provide producer services. The Board ultimately held that the \$500,000 in
19 compensation was for services provided from that date through June 30, 1976. The Board specifically
20

21 ¹⁶ The issue in *Gustafson* was how much of a California credit was the taxpayer allowed for taxes paid to Nebraska. It was in
22 the taxpayer's best interest to increase the allocation to Nebraska in order increase the credit, while it was in respondent's best
23 interest to increase the allocation of work to California in order to decrease the credit.

24 ¹⁷ The Board added that "[i]f the services he performed during his visits to Nebraska, for example, were of greater value or
25 generated a greater pro rata amount of income for appellant than the phone calls made from California, appellant should have
26 so demonstrated. As is, appellant has failed to meet his burden of proving [respondent's method] intrinsically arbitrary or
27 unreasonable."

28 ¹⁸ Staff notes that the formula at issue in *Union Carbide* was a statutory income tax apportionment formula, not an ad hoc
allocation formula for personal income tax purposes. The legal presumption of correctness advanced by the *Union Carbide*
case was a well-understood U.S. Constitutional presumption that, in order for a taxpayer to constitutionally prevail against a
state's apportionment formula, it must demonstrate that the apportionment formula was unreasonable or intrinsically arbitrary
in that it taxed income out of proportion with the taxpayer's activities within the state. (*See Hans Rees' Sons, Inc. v. North
Carolina* (1931) 283 U.S. 123.)

1 referenced the language of Subdivision (b) and sanctioned the use of a workday-based allocation
2 formula to allocate income from the \$500,000, \$300,000 of which was payable in the 1975 tax year and
3 \$200,000 payable in 1976 (*i.e.*, from May 15, 1975 to June 30, 1976). In reaching this conclusion, the
4 Board stated that "since the total of \$500,000 covered two years, we find that a reasonable attribution
5 would encompass the entire period." Using this formula, there were 384 total days, 120 of which were
6 in California (over 1975 and 1976) (*i.e.*, 31.2 percent) while the remainder of 264 days (or 68.8 percent)
7 were for days worked outside of California. With these percentages, the Board attributed \$156,000 of
8 the \$300,000 to California (apparently 31.2 percent times \$500,000) as California source income for
9 1975 and the remainder (\$144,000, presumably \$300,000 minus \$156,000) "together with the \$200,000
10 paid to him in 1976 to be attributed to services performed by him outside of California."

11 Regulations

12 A regulation under the APA is broadly defined as every rule, regulation, order, or
13 standard of general application or the amendment, supplement, or revision of any rule, regulation, order,
14 or standard adopted by any state agency to implement, interpret, or make specific the law enforced or
15 administered by it, or to govern its procedure. (Cal. Gov. § 11342.600)

16 Under the APA, no state agency shall issue utilize, enforce, or attempt to enforce any
17 guideline, criterion, bulletin, manual, instruction, order, standard of general application, or other rule,
18 which is a regulation, unless the guideline, criterion, bulletin, manual, instruction, order, standard of
19 general application, or other rule has been adopted as a regulation and filed with the Secretary of State.
20 (Gov. Code § 11340.5.)

21 The case of *Tidewater Marine Western, Inc. v. Bradshaw*, (1996) 14 Cal. 4th 557,
22 provides that one purpose of the APA is:

23 to ensure that those persons or entities whom a regulation will affect have a voice in its
24 creation, as well as notice of the law's requirements so that they can conform their
25 conduct accordingly. The Legislature wisely perceived that the party subject to
26 regulation is often in the best position, and has the greatest incentive, to inform the
27 agency about possible unintended consequences of a proposed regulation. Moreover,
28 public participation in the regulatory process directs the attention of agency policymakers
to the public they serve, thus providing some security against bureaucratic tyranny.

(*Tidewater* at 568-69 (citations omitted).)

Further:

1 A regulation subject to the APA has two principal identifying characteristics. First, the
2 agency must intend its rule to apply generally, rather than in a specific case. The rule
3 need not, however, apply universally; a rule applies generally so long as it declares how a
4 certain class of cases will be decided. Second, the rule must implement, interpret, or
5 make specific the law enforced or administered by [the agency], or . . . govern [the
6 agency's] procedure.

7 (*Tidewater* at 571 (citations omitted).)

8 Interpretations that arise in the course of case-specific adjudication are not regulations,
9 though they may be persuasive as precedents in similar subsequent cases. (*Id.*)

10 Interpretive regulations are entitled to consideration and respect by the courts. (*Yamaha*
11 *Corp. of America v. State Bd. of Equalization*, (1998) 19 Cal. 4th 1.) Quasi-legislative regulations have
12 the effect of a statute. (*Id.* at 1.) Since R&TC section 17954 expressly authorizes/mandates respondent
13 to implement allocation regulations, it appears that CCR section 17951-5 constitutes a quasi-legislative
14 regulation.

15 Constitutional Issues

16 The California Constitution, Article III, section 3.5, subdivision (a), provides that an
17 administrative agency has no power to declare a statute unconstitutional, or to refuse to enforce a statute
18 on the basis of its being unconstitutional, unless an appellate court has made a determination that the
19 statute is unconstitutional. Further, the Board has a well-established policy of abstention from deciding
20 constitutional questions in an appeal involving proposed assessments of tax. (*See e.g., Appeals of Fred*
21 *R. Dauberger, et al.*, 82-SBE-082, Mar. 31, 1982; Cal. Code Regs., tit. 18, § 5412, subd. (b)(1).)

22 Late Filing Penalty

23 R&TC section 19131 requires respondent to impose a late filing penalty when a taxpayer
24 fails to make and file a return on or before the required due date. This penalty cannot be imposed if the
25 failure is due to reasonable cause and not due to willful neglect. To establish reasonable cause, the
26 taxpayer must show that the failure to file timely returns occurred despite the exercise of ordinary
27 business care and prudence, or that cause existed as would prompt an ordinary intelligent and prudent
28 businessperson to have so acted under similar circumstances. (*Appeal of J. Morris Forbes and Leila G.*
Forbes, 67-SBE-042, Aug. 7, 1967.) In addition, respondent's determination with respect to the late
filing penalty is presumed correct and the burden is on the taxpayer to prove otherwise. (*Appeal of*

1 *Myron E. Gire and Alice Z. Gire*, 69-SBE-029., Sept. 10, 1969.) Ignorance of the law, generally, does
2 not constitute reasonable cause. (*Appeal of Elmer R. and Barbara Malakoff*, 83-SBE-140, June 21,
3 1983.)

4 In *United States v. Boyle*, (1985) 469 U.S. 241, a taxpayer relied on its attorney to file an
5 estate tax return by the required deadline. When the attorney failed to do so, the taxpayer argued that his
6 (the taxpayer's) failure to file the return was due to reasonable cause since he relied on his attorney. The
7 Supreme Court acknowledged that attorney reliance was traditionally allowed to demonstrate the
8 existence of reasonable cause, and indicated that engaging an attorney to assist in the probate
9 proceedings is plainly an exercise of "ordinary business care and prudence." (*Boyle* at 250.) However,
10 the Supreme Court in *Boyle* found that the filing deadline statute was unambiguous and that the
11 taxpayer's attorney-based reliance in that matter did not concern advice on a question of law. (*Id.*) The
12 Supreme Court explained this distinction as follows:

13 When an accountant or attorney advises a taxpayer on a matter of tax law, such as
14 whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most
15 taxpayers are not competent to discern error in the substantive advice of an accountant or
16 attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or
17 to try to monitor counsel on the provisions of the Code himself would nullify the very
18 purpose of seeking the advice of a presumed expert in the first place. 'Ordinary business
19 care and prudence' do not demand such actions.

By contrast, one does not have to be a tax expert to know that tax returns have fixed
filing dates and that taxes must be paid when they are due.

(*Boyle* at 251 (citations omitted))

STAFF COMMENTS

Issues (1) and (2) – Proper Allocation Methodology for NQSOs and Restricted Stock

Here, the Board must decide how appellants' compensatory income from the exercise of
NQSOs and the vesting of restricted stock should be allocated as California source income under R&TC
section 17951, where the taxpayer has worked as a nonresident outside of California prior to the exercise
or vesting of the NQSOs or restricted stock, respectively.

Publication 1004

Respondent's multi-year calendar formula for NQSOs in this case appears very similar to
respondent's multi-year approach as articulated in Publication 1004, with modifications made to a

1 calendar day basis.¹⁹ Respondent does not claim Publication 1004 is a rule or regulation and asserts that
2 R&TC section 17954 provides that income of nonresidents "shall be allocated and apportioned under
3 rules and regulations prescribed by the Franchise Tax Board." Thus, if the Board enforces respondent's
4 calendar formula on the basis that it exists in a guideline publication (expressly for NQSOs or impliedly
5 for restrictive stock), then the Board ought to consider whether this would be contrary to GC section
6 11340.5, which prohibits any agency from enforcing a rule that has not been through the regulatory
7 process. Alternatively the Board need not rely on the publication and may instead rely on the applicable
8 statutes and regulations, together with relevant case law and prior Board decisions, in determining this
9 appeal. Staff notes that it appears that appellants are contending that the facts of this case are
10 sufficiently removed from the original facts described in Subdivision (b) (which ostensibly involves
11 nonresident "interval workers" earning income within and without California within a single taxable
12 year), that respondent's application/interpretation of Subdivision (b) in this case is an underground
13 regulation.

14 *Plain Language Approach to Subdivision (b)*²⁰

15 It appears that CCR section 17951-5 from inception was drafted to allocate compensation
16 earned from the performance of personal services within California. Subdivision (a)(1) provides a rule
17 for traveling salespersons whose income is directly based on sales volume. Subdivision (a)(2) handles
18 entertainers of all sorts coming to California for performances. Subdivision (a)(3) handles professionals
19 who may perform services for clients in California. These professionals' income is allocated based on
20 the fees or compensation paid for the services performed by these individuals in California. Subdivision
21 (a)(4) appears to be a general provision for all other types of employees (even officers of
22 corporations).²¹ If such employees are "employed continuously in this State for a definite portion of any
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25 ¹⁹ Respondent's calendar year formula for restrictive stock, although not discussed in Publication 1004, is consistent with the
26 multi-year approach taken in Publication 1004.

27 ²⁰ The California Supreme court held that in interpreting a statute, we begin with the words of the statute and give them their
28 ordinary meaning. (*Hoechst Celanese Corp. v. Franchise Tax Bd.*, (2001) 25 Cal. 4th 508, 519).

²¹ It appears this parenthetical comment in the regulation relating to corporate officers may have been due to a possible
argument back in 1937 that an officer of a corporation may not be an employee, and therefore not subject to this provision of
the allocation regulation.

1 taxable year, the gross income of the employees from sources within this State includes the total
2 compensation for the period employed in this State." It does appear that subdivision (a)(4) may have
3 some relevance to the overall issue of this case, since appellant-husband was an employee for a
4 continuous period of time within California.²² Finally, Subdivision (b) appears to apply to another
5 subset of employees, employees working at intervals, who may not fit well in subdivision (a)(4).

6 Accordingly, the first issue for the Board to decide (and which the parties should be
7 prepared to discuss) is whether Subdivision (b) is an ad hoc (i.e., based on the facts and circumstances of
8 each case) allocation provision specifically limited to finding ways to allocate income from personal
9 services income received by employees whose profession required interval periods within and without
10 California "throughout the year" (i.e., a single taxable year),²³ or whether it applies more broadly to
11 employees that might not fit well within the category of "interval" workers that work within and without
12 California throughout the taxable year.

13 *Case Law*

14 The Board cited Subdivision (b) in *Appeal of Sam and Betty Spiegel, supra* to allocate a
15 nonresident's contractual income received for services performed over two years. Thus, it appears that
16 regardless of the plain language or original intent of Subdivision (b), the Board has referenced
17 Subdivision (b) outside of the transportation employee context for the proposition that income earned
18 over a multi-year period by a movie producer could be allocated.

19 It appears that in the *Newman* case cited above, the California court of appeal referenced
20 Subdivision (b) outside of the transportation employee context to support an "ad hoc" duty day
21 allocation formula for a film contract for acting within California that lasted wholly within 1973 and
22 later applied this formula for income received in later tax years. There, during the period of the contract,
23 the performer was entering and leaving California apparently on a regular basis. Accordingly, the

24
25
26 ²² It appears that subdivision (a)(4) may be a better "catch all" provision for regular employees and better fit for the facts of
27 this case than Subdivision (b). However, it is not clear whether by referring to a "nonresident employee," subdivision (a)(4)
28 should be limited to nonresidents coming to work for a portion of the tax year within California, or whether this language can
be broadly construed to apply to multiple tax years for "California residents, who subsequently become nonresident
employees" who later receive income that relates back to their residency period, i.e., "for the period employed in this State."

²³ The first sentence of CCR section 17951-1 mentions "throughout the taxable year" it does not mention multiple years.

1 parties should be prepared to discuss:

- 2 1. Whether the *Newman* case (together with *Speigel, supra*) support the contention that Subdivision
3 (b) should be relegated to "ad hoc" situations (difficult contracts) or applicable to support a
4 general rule for NQSOs and restricted stock;
- 5 2. Whether those cases represented special interval worker situations, or whether they represent an
6 application/expansion of Subdivision (b) beyond the interval worker context.

7 Staff notes that appellants are arguing that whatever allocation formula is applied, it must
8 be reasonable. Thus, it seems that even if appellants' contention that the calendar formula is not
9 provided for in the regulations or in Subdivision (b), appellants still agree and contend that the allocation
10 rule that should be applied must be reasonable.

11 Thus, it appears to staff that if the Board agrees with respondent's interpretation of
12 Subdivision (b) and agrees that respondent's allocation formula should be upheld unless it can be shown
13 that it is arbitrary or unreasonable, then respondent's workday formula should be applied unless
14 appellant can demonstrate that respondent's formula is arbitrary or unreasonable. On the other hand, if
15 the Board determines that Subdivision (b), does not apply or disagrees with respondent's reliance upon
16 Subdivision (b) for the authorization of respondent's calendar formula, the Board must still determine
17 how the income at issue should be allocated for California sourcing purposes.

18 As for the economic principles for restricted stock, it appears to Board staff that restricted
19 stock constitutes incentive compensation designed to induce employees into continued employment over
20 a designated incentive period. The incentive period typically begins upon the grant date and typically
21 ends when the restricted stocks' incentive "powers" end.²⁴ Thus, it would appear that the grant date to
22 vesting date represents the natural inducement life for restrictive stock and that the incentive period
23 corresponds to the period when the restrictive stock is earned (i.e., the earning period). The vesting date
24 also represents the point in time for tax purposes when restricted stock must be taken into income (the
25 recognition event). Thus, the parties should discuss whether respondent's use of the grant date to the
26 vesting date for purposes of applying the calendar day formula for tax purposes for restrictive stock
27

28 ²⁴ Appellants apparently concur with this observation in conceding a grant date to vesting date allocation period is plausible for NQSOs.

1 fairly aligns the economic incentive/earning period to the taxable earning period with the tax due upon
2 recognition (the vesting date).

3 With respect to NQSOs, the question is whether the "earning/incentive" period (and
4 therefore the allocation period to be used in any multi-year calendar formula) should be from the grant
5 date to the vesting date, or from the grant date to the exercise date. Both parties agree that the NQSOs
6 do not result in taxable income until they are exercised under the rules of IRC section 83 (no Form W-2
7 is issued upon the vesting of NQSOs) and vesting of NQSOs does not result in the recognition of any
8 income. One argument favoring the grant to exercise date would be that all income upon recognition of
9 a NQSO is compensation income and is arguably "earned" from the grant date to the exercise date.²⁵

10 Accordingly, at the oral hearing, the parties should be prepared to discuss whether
11 respondent's allocation methodology is reasonable on the facts of this case, or whether appellants' Year
12 of Exercise Rule or Single-Year Vesting Rule, which limits the allocation days to the single year of
13 exercise, or vesting, respectively, are the better approaches.

14 Issue (3) – Reasonable Cause Abatement

15 Appellants did not file a 2003 or 2004 California return 540NR. Instead, appellants
16 agreed to respondent's audit findings imposing the late filing penalties and paid the amounts owed, later
17 filing claims for refund (540X amended returns) of the amounts paid subsequent to audit. It does not
18 appear that appellants are asserting they had reasonable cause for the failure to file their 2003 and 2004
19 returns by the due dates. Accordingly, at the oral hearing the parties should be prepared to discuss
20 whether appellants' failure to file returns for 2003 and 2004 occurred despite their exercise of ordinary
21 business care and prudence, such that reasonable cause exists for abatement of the penalties.

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24 _____

25 ²⁵On the other hand, an economic argument in favor of using grant date to vesting date) is that, arguably, after the vesting
26 date, there is no longer any "incentive" power left: the employee can exercise the NQSO at will and that any income "earned"
27 after the vesting date was not really "earned" from employment within California, but was "earned" in the marketplace (by
28 holding an option for stock) that could be earned at any time, without regard to continued employment with the employer that
issued the original NQSO. This argument may not be as strong for upper managerial employees whose continued
performance beyond the vesting date could materially affect the value of the stock (and therefore their wage income.) Here,
appellant was a manager from 1988 to 1998 when he became an executive employee. (Resp. Opening Br., exhibit A.)