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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 **DAVID LAIL AND KAREN LAIL¹**) Case No. 439458
13)

| <u>Year</u> | <u>Proposed Tax</u> | <u>Post-Amnesty Penalty</u> |
|-------------|---------------------|-----------------------------|
| 2000 | \$227,024 | \$17,024 |

17 Representing the Parties:

18 For Appellant: Christopher S. Manes, Attorney

19 For Franchise Tax Board: Natasha Sherwood Page, Tax Counsel III

21 **QUESTIONS:** (1) Whether income in the amount of approximately \$8.8 million received by
22 appellants in 2000 should be classified as wages or royalties.

23 (2) Whether the Board has jurisdiction to abate the post-amnesty penalty.

24 HEARING SUMMARY

25 Background

26 In 2000, appellant-husband was an investment banker involved in municipal finance and
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28 ¹ Appellants reside in Montana.

1 a senior vice president at George K. Baum and Company (GKB). (Resp. Opening Br., p.1.) For tax year
2 2000, appellants filed a federal form 1040 reporting “wages, salaries, tips, etc.” of \$8,790,221. (Resp.
3 Supp. Br., exh. A, p. 13.) For California purposes, appellants filed a 2000 California Nonresident or
4 Part-Year Resident Return identifying \$573,430 in “total California wages from all your Form(s) W-2,
5 box 17” (*Id.* p. 1.) and indicating that their California residency ended on June 1, 2000, when they
6 became Florida residents. (*Id.* p. 4.) The original California return indicates that the remaining wages
7 were earned while appellants were Florida residents. (*Id.*)

8 Respondent accepted the residency change at audit and inquired further to determine if a
9 portion of the \$8.2 million should have been sourced to California. Respondent concluded that the bulk
10 of this amount was from “bonuses” received by appellant-husband for services provided to GKB during
11 the period that appellants were not residents of California. (Resp. Opening Br., p. 1.) Respondent
12 determined that appellant-husband was involved in several financing transactions from which he earned
13 approximately \$8 million. Respondent questioned appellants about where the services for these projects
14 were performed and respondent states that at audit, appellants did not provide any supporting
15 documentation. (Resp. Opening Br., p. 2.) As a result, respondent utilized a working days formula for
16 appellants’ nonresidency period from June 2000 to December 2000. The formula apportioned
17 appellants’ income within and without California based on a ratio of 46.5 days within California to
18 152.0 working days in and out of California. (Resp. Opening Br., p. 2.) Respondent issued a Notice of
19 Proposed Assessment (NPA) based on this apportionment formula which assessed \$230,847 in
20 additional tax, plus a post-amnesty penalty and interest. (Appeal Letter, exh. 2.)

21 At protest, appellants contended that the bonus wages were incorrectly classified and
22 should have been treated as royalty income. Appellants claimed that such royalties were received while
23 appellants were residents of Florida and should therefore be sourced to Florida. GKB subsequently
24 issued a revised Federal Form W-2c, reporting appellant-husband’s wages from January to May 2000 as
25 California state wages and removing all Texas source income.² Respondent claims that at protest the
26 amount of income was reduced to properly reflect payments of income, and affirmed the NPA (with a
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28 ² In this corrected Form W-2c, GKB again identified the payments as wages/compensation.

1 small reduction) in a Notice of Action (NOA), dated December 5, 2007. This timely appeal followed.
2 (Resp. Opening Br., p. 3.)

3 **Issue 1: Whether payments in the amount of approximately \$8.8 million received by appellants in**
4 **2000 should be classified as wage income or royalties for California income tax purposes.**

5 Contentions

6 Appellants' Contentions

7 Appellants contend that the income at issue is derived from non-California source
8 royalties that accrued after they established residency outside of California. (Appeal Ltr., p. 2.)
9 Appellants contend that while living in Texas appellant-husband developed and became proprietor of an
10 innovative financing structure for bond sales. (Appeal Ltr., p. 2.) Appellants state that appellant-
11 husband entered into an oral employment agreement with GKB relating to marketing bonds under his
12 proprietary financing structure. Appellant-husband indicates that his compensation from GKB had three
13 elements:

- 14 1. a royalty based on a percentage of the revenue generated from a particular transaction;
- 15 2. meeting with prospective clients;
- 16 3. conducting and finalizing the bidding of certain investment agreements used in the transaction.

17 (Appeal Ltr., pp. 2-3, hereafter the Three Elements of Compensation.) Appellant-husband contends that
18 during 2000, several transactions were initiated, but the vast bulk of them were consummated after May
19 2000. (Appeal Ltr., p. 3.) Appellant-husband indicates that the original W-2 issued to him from GKB
20 was in error and that GKB "corrected this mistake by issuing" a "Transaction Schedule" showing what
21 portion of the payments was royalty-based. (Appeal Ltr., p. 3; App. Reply Br., p. 3.) Appellants also
22 refer to the provision of the Transaction Schedule as a "repudiation of the Form W-2's characterization
23 of the payments." (App. Reply Br., p. 6.) Appellants contend that case law holds that the Form W-2 is
24 not dispositive as to the amount and type of income reported by an employer. (Appeal Ltr., p. 4.)³
25 Appellants claim that all payments made after May 2000 were royalties and constituted non-California
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28 ³ Appellants cite two Board summary decisions, *Appeal of Jon. D. Sutcliffe*, No. 97A-1400, Nov. 5, 1998 and *Appeal of Vincent and Mitzi Testaverde*, No. 99A-0197, Feb. 1, 2000 to support their contention that information on a Form W-2 is not conclusively correct. Board staff notes that summary decisions are not to be cited as precedent in any appeal or proceeding before the Board. (Cal. Code Regs. tit. 18, § 5451, subd. (d).)

1 source income.

2 Appellants state that the terms of the royalty payments were as follows:

3 Mr. Lail was to receive at least 40% of the total revenue paid to GKB for any
4 Transaction, whether closed by Mr. Lail or some other banker, whether he worked on the
5 Transaction or not. The 40% figure varied only to the extent that Mr. Lail was willing to
6 take less in order to provide “bonus” compensation to other bankers who worked on the
7 deal and made a special contribution through the work effort or client contacts. The only
8 work Mr. Lail ever did on any of the Transactions was to bid the investment agreements,
9 a process that involved faxing bid packages to bidders and taking their questions over the
10 phone. The only reason Mr. Lail handled this part of the deal personally was that the
11 questions could get extremely technical and legal at times, and Mr. Lail was best suited to
12 answer correctly.

9 (App. Reply Br., pp. 2-3)

10 Appellants provide a declaration from Mr. Michael Davis (an investment banker with
11 GKB who was the “lead” banker in the sale of the bonds at issue) in which he states that GKB
12 investment bankers are paid a percentage of revenue from a deal “based on the creation or development
13 of a unique financing structure or product essential to the financing.” (Appeal Ltr., p. 6; App. Supp. Br.,
14 p. 5.) Appellants state that Mr. Davis attests that appellant-husband’s financing concepts were “vital
15 elements” of the projects at issue, were the basis of his compensation, and were developed by appellant-
16 husband prior to 1998. (Appeal Ltr., p. 6.)

17 Appellants also provide another declaration from Robert Dalton, vice chairman of GKB,
18 in which he states “GKB paid [appellant-husband] ‘based on a percentage of revenue’ derived from the
19 transactions at issue, and he got paid for that idea” and his “right to the percentage was unrelated to his
20 services.” (Appeal Ltr., p. 6.) Appellants state that Mr. Dalton also attested in a letter dated July 26,
21 2007, that “[appellant-husband] ‘formulated a financing plan’ for the transactions at issue, and he got
22 paid for that idea.” (Appeal Ltr., p. 6.) Appellants also contend that the Transaction Schedule
23 demonstrates that “unequivocally for each transaction at issue, amounts paid to [appellant-husband]
24 were attributable to ‘development of financing structure.’” (Appeal Ltr., p. 6.) Appellants contend that
25 GKB has provided a “clear-cut admission” that the Form W-2 issued to appellant-husband was
26 inaccurate and that respondent has not rebutted that evidence. Furthermore, appellants argue that the
27 courts have held that respondent may not consider evidence that a Form W-2 is inaccurate and not
28 dispositive when it supports respondent’s determination but disregard evidence that a Form W-2 is

1 inaccurate when it does not benefit respondent. (Appeal Ltr., p. 6.)

2 Appellants contend respondent's determination is based solely on the "repudiated" Form
3 W-2, and argue that courts must look to all the facts and circumstances to determine the character of
4 income. (App. Reply Br., p.3.) Appellants assert that they provided "overwhelming evidence" that the
5 payments were royalties and they reference the declarations, the bond prospectuses, and the Transaction
6 Schedule. According to appellants, the evidence shows appellant-husband was paid only for
7 transactions that used his financing structure, it is industry practice to pay royalties for financing
8 structures, the payments accrued to appellants when they were not residents of California and GKB
9 repudiated the Form W-2 to the extent it characterized the payments as compensation for services. (App.
10 Reply Br., pp. 3-4.)

11 Appellants argue that respondent mischaracterizes the evidence in the following ways:

- 12 • Mr. Dalton in his declaration and in the letter dated July 26, 2007, makes clear that appellant-
13 husband's right to a percentage of the revenue was based on the financing plan he developed and
14 was not related to the services he performed.
- 15 • Mr. Davis in his declaration stated that investment bankers are paid a percentage of revenue from
16 a deal based on the creation or development of a financing structure and the financing structures
17 developed by appellant-husband in 1998 were "vital elements" of the payments.
- 18 • The Bond Statements (the official statements for the bond offerings) confirm that each of the
19 transactions had the same financing structure, which the declarations establish were developed
20 by appellant-husband. The record shows appellant-husband was paid only for the transactions
21 that used his financing structure which is not attributable to mere coincidence. Therefore, it is
22 irrelevant that the Bond Statements do not mention appellant-husband.
- 23 • The Transaction Schedule shows that the payments were attributable to appellant-husband's
24 development of a unique financing structure and thereby repudiates the Form W-2. The
25 reimbursement of appellant-husband for out-of-pocket expenses incurred in connection with the
26 transactions is not inconsistent with the character of the payments as royalties. The Transaction
27 Schedule also shows that appellant-husband made very few trips during this period while the
28 payments amount to approximately \$8 million. Thus, such a large amount is more consistent

1 with royalties than compensation for services.

2 (App. Reply Br., pp. 4-7.)

3 In response to Appeals Division staff's request regarding the nature of the intellectual
4 property allegedly licensed to GKB from appellant-husband, appellants state that the financing
5 mechanism was "in essence a new type of security" known as the GKB Municipal Pooled Loan Funding
6 Program (Pools), which was developed solely by appellant-husband in response to changes brought
7 about by the Tax Reform Act of 1986 (and subsequent amendments). Appellants explain that the 1986
8 Act severely restricted the ability of municipalities to pay for the issuance costs of tax-exempt bonds,
9 which were significant in most cases, out of earnings derived from the investment of such bond proceeds
10 (i.e., arbitrage earnings). As a result of those restrictions, appellant-husband, a former attorney working
11 as an investment banker, began developing a series of financing programs for municipal issuances of
12 tax-exempt mortgage-backed housing bonds in the 1990s that became quite successful and created the
13 professional framework within which appellant-husband subsequently developed the Pools for the
14 transactions at issue in this appeal. (App. Supp. Br., pp. 2-3.)

15 After the successful implementation of the housing/mortgage program, Mr. George K.
16 Baum (of GKB) tasked appellant-husband with assembling a team of investment bankers to establish an
17 office in Houston, Texas and to manage its daily operations. (App. Supp. Br., p. 3.) Appellants contend
18 that appellant-husband's reputation in the industry was valuable to GKB for attracting business and
19 launching the Texas office, for which he received a modest salary. It was during this time around 1998
20 that appellants claim appellant-husband developed the Pools which invigorated the municipal bond
21 market and became the proprietary program (Program) for the transactions at issue in this appeal.
22 Appellants contend the Program was highly successful and that its details could be kept a trade secret
23 because "it depended on derivatives in the secondary market which by law did not have to be disclosed."
24 (App. Supp. Br., p. 4.)

25 Appellants contend that appellant-husband was not paid by GKB to develop the Program,
26 but rather he was paid to launch and operate the day-to-day business of the Texas office. (App. Supp.
27 Br., p. 4.) Appellants further contend that appellant-husband offered the Program to GKB for a payment
28 of royalties by GKB in the 40 percent range and that if GKB had not agreed to those payment terms,

1 appellant-husband would have offered the Program to another underwriter. Appellants contend GKB
2 never claimed ownership in the Program and it is not an asset that appears on any of GKB's filings with
3 the Securities and Exchange Commission (SEC) or on GKB's balance sheet. (App. Supp. Br., p. 5.)

4 Appellants state that the Program was not patented as it was not industry practice to
5 patent bond-related financial products because they tend to have short "shelf lives". Moreover,
6 appellants contend that for tax purposes, in determining whether a payment is wages for services or a
7 royalty for use of intellectual property, the intellectual property need not be patented or copyrighted.
8 Appellants also state that it is industry practice for underwriters like GKB to pay royalties to developers
9 of financial products, like appellant-husband, based on an oral contract and to use a Form W-2 to report
10 the income. (App. Supp. Br., pp. 5-6.)

11 In response to the Appeals Division staff's question as to whether GKB subsequently
12 corrected the Form W-2 with the Internal Revenue Service (IRS) (i.e., by issuing a Form 1099),⁴
13 appellants stated that appellant-husband was not in control of how GKB characterized its payments and
14 that the Forms W-2 issued in this case are not dispositive as to whether the income was wage
15 compensation or royalties. (App. Supp. Br., p. 6.)

16 In response to the Appeals Division staff's inquiry as to whether GKB subsequently
17 sought a refund of the employment taxes collected and remitted by GKB on the payments, appellants
18 assert that "the evidence is overwhelming, and unrebutted, that the payments cannot be wages for
19 services despite the Form W-2." In support of their assertion, appellants cite the following facts: (App.
20 Supp. Br., pp.7-8.)

- 21 • GKB provided a listing of compensation for appellant-husband for 2000 which shows that he
22 was paid \$7,291.67 per month in 2000, while the remaining payments of nearly \$8.5 million
23 were bonuses (i.e., the royalty payments at issue). Appellants contend a "bonus" of \$8.5 million
24 on a base salary of \$175,000 is not reasonable compensation for services performed, especially
25 when such services appear to be minor. Rather, that amount is consistent with a royalty
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28 ⁴ Board staff requested this additional information since royalties are typically reported on a Federal Form 1099-MISC, box 2; while employee wage compensation is reported on a Form W-2 and a failure to provide correct information reports to an employee can result in penalties to the issuer of the federal information report.

1 payment.

- 2 • A “discretionary bonus” of \$250,000 was paid to appellant-husband in November 2000, which,
3 when contrasted with the \$8.5 million bonus, indicates that the \$8.5 million bonus was not
4 discretionary at all but instead was a royalty. Appellants contend that respondent has not shown
5 why appellant-husband would be paid a \$8.5 million bonus for services rendered when the
6 discretionary bonus is 50 times smaller.
- 7 • Appellants claim the Transaction Disbursement Schedule shows that the payments in issue were
8 attributable to appellant-husband’s development of a financing structure which is consistent with
9 a royalty payment of \$8.5 million.
- 10 • Mr. Davis’s declaration that payment for proprietary ideas is standard practice in the industry is
11 consistent with the argument that the payments were a royalty.
- 12 • GKB provided a letter (from Jullee Windle, Assistant Vice President of GKB, dated August 16,
13 2004) (*see* App. Supp. Br., p. 8 and exh. 4) indicating that appellant-husband had no formal
14 written employment contract with GKB and that his bonuses were paid based on the type of bond
15 issue by oral agreement.
- 16 • Numerous percipient witness declarations to the effect that appellant-husband was paid royalties
17 for the Program.
- 18 • GKB’s Statement of Financial Condition for the Period November 1, 2000 to October 31, 2001,
19 in the Annual Audit Report filed with the SEC (App. Supp. Br., p. 9 and exh. 5) shows that GKB
20 does not own any financial product assets and that under “other assets” it shows a value of \$4.9
21 million, which is half of the \$8.5 million paid to appellant-husband in 2000 and 2001.
- 22 Appellants claim these figures are inconsistent with Respondent's suggestion that GKB owned
23 the Program and merely paid appellant-husband as an employee to develop it for GKB’s use.
- 24 • The Official Bond Statements show that appellant-husband only worked on and only got paid for
25 bond issuances using the Program. In addition, GKB underwrote other bond issues, not using the
26 Program, for which appellant-husband was not compensated. (App. Supp. Br., pp. 9-10).

27 In response to Appeals Division Staff's request for the parties to discuss relevant case law
28 that distinguishes the payment of wages versus royalties to employees, appellants cite Private Letter

1 Ruling (PLR) 253139-96 (March 25, 1997) and Chief Counsel Advice Memoranda (CCA) 200305007
2 (Sept. 26, 2002). (App. Supp. Br., p.10.) Appellants state that PLR 253139-96 involved a certified
3 public accountant (CPA) who purportedly entered into a licensing agreement with his employer.⁵ Citing
4 various authorities, the PLR distinguished the payment of a royalty from wages by looking to the
5 economic substance of the transaction. Appellants contend the PLR stands for the proposition that the
6 parties' characterization of payments does not control the taxability of payments and they cite *Phillies v.*
7 *U.S.* (Pa. E.D. 2001) 153 F. Supp. 2d 612. Under this test, the PLR determined that the payments to the
8 CPA were wages since all were related to services. In applying the PLR here, appellants contend the
9 economic substance of the transactions indicate the salary for appellant-husband's services was minimal
10 compared to his bonus payments and this arrangement only makes sense if the bonus payments were
11 considered royalties. (App. Supp. Br., p. 11; App. Add'l Br., p. 3.)

12 Appellants state that CCA 200305007 involved a musician hired by a music publisher
13 under a written contract to pay "royalties" based on a percentage of the music products sold. The IRS
14 held that the payments were all related to the musician's services and no amount was paid for the use of
15 property and so the payments were deemed wages. Appellants contend the opposite is true in this case,
16 such that only minimal services were performed by appellant-husband and he only received payment if a
17 bond issuance using the Program closed. Thus, under the reasoning of *Sierra Club v. Comm'r* (9th Cir.
18 1996) 86 F.3d 1526, appellants argue the bonuses should be treated as royalties. (App. Supp. Br., pp.
19 11-12.) Appellants also contend that the IRS ruled the parties' characterization of income is not
20 dispositive so, as applied to this case, GKB's incorrect characterization of the payments as bonuses was
21 successfully refuted by the declarations of percipient witnesses. (App. Add'l Br., p.2.)

22 In response to the Appeals Division Staff's inquiry regarding the applicability of R&TC
23 section 17554, appellants assert that section is not applicable to the facts of this appeal because that
24 section applies only when the IRC does not prescribe a particular method for reporting the type of
25 income in question. Appellants point out that various methods of accounting for royalties are set forth in
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27 ⁵ Board staff believes appellants inadvertently confused the facts of the cited authorities. PLR 9725037 (March 25, 1997)
28 (which appellants referred to as number 25139-96) involved the musician example and the accountant example was discussed
in CCA 200305007.

1 IRC sections 62(a)(4), 512 and 6050N. (App. Supp. Br., p.12.)

2 Appellants add that even if R&TC section 17554 applied, the facts here fail to meet the
3 two-pronged standard under the *Appeal of Money* test.⁶ Appellants explain that R&TC section 17554
4 generally puts all taxpayers who change their residence on the accrual method of accounting so that a
5 taxpayer's residency at the time the income is earned, rather than when it is received, determines
6 whether it is taxable by California. Appellants further explain that R&TC section 17554, as interpreted
7 by Board formal opinions, only applies to taxpayers who move into California when the subject income
8 is not a pension. Here, appellants argue, appellants accrued non-California source income before early
9 June 2000, relating to various bond issuances, but payment did not occur until they established residency
10 outside of California. Thus, appellants argue that under the *Money* test respondent may not assert
11 residency as a basis for taxation. Appellants also contend that the second prong of the *Money* test does
12 not apply because all payments were made in 2000 regardless of whether they were on the cash basis or
13 accrual method of accounting. However, appellants argue, the payments were made after May 2000
14 when appellant-husband was no longer a California resident so the accounting method does not cause
15 different tax consequences. (App. Supp. Br., pp. 13-14.)

16 Finally, appellants take issue with respondent's contention that respondent is not in
17 control of the documents relevant to this appeal. Appellants assert that GKB is in control of such
18 documents and provided them to respondent. In addition, appellants maintain that the evidence shows it
19 is industry practice to account for banker royalties for financing structures. Moreover, appellants assert
20 it is common practice in the bond industry to conduct large transactions with a "handshake" so there
21 would necessarily be little documentation. With respect to the evidence relied on by respondent,
22 appellants contend the bond purchase agreements are between the bond issuer and underwriter and have
23 no bearing on the characterization of the payments to appellant-husband. On the federal tax return,
24 appellants contend, appellants and their CPA simply reported the income in conformity with the
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27 ⁶ In the *Appeal of Virgil M. and Jeanne P. Money*, 83-SBE-267, decided December 13, 1983, the Board developed what has
28 become known as the "*Money Test*," under which R&TC section 17554 will apply only when two conditions are met:

1. California's sole basis for taxation is the taxpayer's residency; and
2. Tax treatment would differ depending on whether the taxpayer used the accrual or the cash method of accounting.

1 information return provided by GKB, and did not consider the proper characterization of that income.
2 (App. Add'l Br., pp.3-4.)

3 Respondent's Contentions

4 Respondent asserts that, based on the evidence obtained during the audit process, most of
5 the \$8.2 million in income that appellants did not apportion to California was from bonuses received by
6 appellant-husband during his nonresidency period. Respondent further states that the transactions giving
7 rise to most of appellant-husband's bonuses took place in five other states, which were not the location
8 of his services. Respondent states that at audit, when it questioned appellant-husband regarding the start
9 dates, end dates and location where the services were provided for these transactions, no supporting
10 documentation was provided. Instead, appellants provided declarations from appellant-husband and his
11 employer which state that appellant-husband did not perform substantial services for a project until
12 shortly before closing and that none of the work was done in California. Due to a lack of corroborating
13 evidence, respondent apportioned appellant-husband's nonresidency bonuses and regular wages to
14 California under the workday formula. (Resp. Opening Br., p. 2.)

15 Respondent contends that appellants changed their position at protest and argued the
16 bonus payments were royalty income taxable by Florida. Respondent characterizes appellants' position
17 at protest as an argument that the bonuses were "based on the performance of rank and file sales agents
18 and [appellant-husband] basically received commissions in the form of bonuses from their sales."
19 (Resp. Opening Br., p.3.)

20 Respondent states that GKB originally issued a Form W-2 showing \$8.607 million in
21 wages, with Florida wages listed as \$8.055 million and Texas wages as \$551,760. Respondent contends
22 that a revised 2000 Form W-2 (Form W-2c) was provided reporting all of the income as California
23 wages and removing all Texas-sourced income. Respondent contends that at protest the "amount of
24 income was reduced to properly reflect the payments of income." However, respondent contends that it
25 is not solely relying on the Form W-2 in this case. In addition to the Form W-2, respondent states it
26 reviewed contracts, accounting statements from GKB, declarations from fellow employees, travel
27 records and other documents to determine the character of the payments in issue. (Resp. Opening Br.,
28 pp. 3-4.)

1 Respondent states the information provided shows that appellants continued to own their
2 California home in Palm Desert and this address was used as the contact address in several of the
3 transactions at issue well past the audit period. Respondent also states that travel records show
4 appellant-husband continued to travel from Palm Desert well into the audit period. On that basis,
5 respondent concludes that appellant-husband continued to work in California after his change of
6 residency. (Resp. Opening Br., p.4.)

7 Respondent contends that the Form W-2 reporting the income as wages is “highly
8 persuasive” in that GKB paid employment taxes above and beyond the payments it made to appellant-
9 husband and appellant-husband’s income statement for Social Security purposes will reflect the \$8
10 million received from GKB. Respondent further contends that GKB did not issue any other information
11 statements contradicting its original characterization of the payments as a wage income. (Resp. Opening
12 Br., p.4.)

13 In addition to the Form W-2 reporting, respondent contends that appellants’ own
14 contentions regarding the Three Elements of Compensation indicate that the amounts received were
15 wage compensation for services. Respondent claims the first element indicates how GKB is to measure
16 the compensation and the other two elements show that appellant-husband was to provide services to
17 receive the income. Because appellant-husband was in the employ of GKB at the time he “invented” the
18 financing structure, respondent contends that it is possible GKB owned the proprietary rights and,
19 furthermore, respondent argues that appellant-husband presented no evidence that the payments were
20 from the licensing of intangible property. (Resp. Opening Br., p.4.)

21 Respondent contends that appellants’ federal income tax return (Form 1040) also
22 supports respondent’s position because appellants confirmed the characterization of the Form W-2 by
23 attaching it to their federal return and signing the return under penalty of perjury. (Resp. Reply Br., p.
24 3.) Respondent contends the Form W-2 shows that GKB withheld \$2,585,338 in federal income tax,
25 \$4,724 in FICA (social security tax) and \$126,405 in Medicare tax. Respondent also notes that GKB, as
26 the employer, would have been required to match the amounts withheld for FICA and Medicare and

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1 remit them to the federal government. (Resp. Reply Br., p. 3, exh. D.)⁷

2 Respondent further asserts that GKB never “repudiated” the Form W-2 but, instead,
3 issued the corrected Form W-2c for the sole purpose of trying to source the income received by
4 appellants. (Resp. Reply Br., p. 3.) Respondent states that the payments are still reported as wage
5 income on the Form W-2c and contends that appellants would like this Board to ignore the most
6 unbiased evidence in this case, i.e., the Forms W-2 and appellants’ federal income tax return. (Resp.
7 Reply Br., p. 4.)⁸

8 Respondent contends the declarations provided by appellants support respondent’s
9 determination that the payments were wage income. Respondent notes Mr. Davis stated in his
10 declaration that: the payments were referred to as “compensation”; that “compensation of bankers at
11 GKB” is typically based on a percentage of revenue production; and that he (Mr. Davis) was an
12 employee of GKB. In view of the compensation structure for bankers at GKB (and respondent’s
13 presumption that not every banker has developed a proprietary structure), respondent concludes that it is
14 very likely appellant-husband was being paid in the same manner as most of the bankers. Respondent
15 surmises that Mr. Davis’s statement to the effect that “the allocation of revenue was generally negotiated
16 between the brokers of a particular deal contradicts the idea that GKB itself had licensed the structure
17 and thereby bore the burden of paying for it.” Respondent, citing *Appeal of Estate of Marilyn Monroe,*
18 *Deceased, 75-SBE-032*, decided April 22, 1975, contends that many employees are paid on a
19 commission basis and basing payments on a percentage of revenue does not indicate the income was not
20 paid for services rendered. (Resp. Reply Br., p. 4-5.)

21 Respondent also contends that Mr. Dalton’s declaration supports respondent’s position by
22 confirming that appellant-husband was an employee of GKB for many years, including the years in
23 which the Program was developed. Respondent contends that no evidence has been provided
24 demonstrating that appellant-husband developed intellectual property outside of his employment
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26 ⁷ Board staff notes that Statement 3 to appellants’ federal income tax return was labeled “Wages Received and Taxes
27 Withheld.” (Resp. Reply Br., exh. D.)

28 ⁸ Appellants countered this contention by stating the issue of whether identifying the income as royalties or wages on the
federal income tax return was not something appellant-husband or his CPA would have in mind in preparing the federal
return. They simply followed the form provided by GKB. (App. Add’l Br., p. 4.)

1 arrangement or that GKB understood it was paying appellant-husband a royalty as opposed to paying an
2 employee for personal services. Respondent contends that no evidence has been provided showing the
3 income received was from the licensing of intangible property. Finally, respondent contends that Mr.
4 Dalton's assertions that appellant-husband did not perform any services in connection with transactions
5 in California during 2000 is a legal conclusion, which is beyond the appropriate scope of a declaration.
6 (Resp. Reply Br., p. 5.)

7 With respect to the Net Management Fee Schedule provided by appellants with the
8 appeal letter, respondent contends the title indicates that appellant-husband was paid management fees.
9 As an example, respondent states that one of the transactions was for an Arizona municipality (Arizona
10 Health Facilities Authority). Respondent contends the first Preliminary Official Statement regarding the
11 bond transaction was dated April 28, 2000. The final statement is dated June 7, 2000. Based on a
12 review of the Net Management Fee Schedule, appellants assert that it shows that appellant-husband
13 began flying to Arizona in connection with this transaction beginning March 1, 2000. Respondent
14 contends these details alone contradict the assertion that the only work appellant-husband ever did was
15 to bid the investment agreements and take questions over the phone, and such activity only took place
16 shortly before the closing. Further, appellant-husband's reimbursement for business travel and other
17 expenses belies the fact that payments to him were royalties and not compensation for services. (Resp.
18 Reply Br., p. 7.)

19 Respondent contends that income from the performance of services within California
20 constitutes California-source income; thus, if a portion of the services was performed in California, a
21 portion of such income is California-source income, regardless of the recipient's state of residence. For
22 these purposes, respondent utilized an allocation formula, which respondent claims was based on
23 California Code of Regulations, title 18, section (Regulation) 17951-5, subdivision (b).⁹ Based on a
24 workday formula, respondent determined that appellant-husband performed services within and without
25

26 ⁹ Board staff notes that appellants have not contended that respondent's allocation formula was (a) an improper application of
27 Regulation 17951-5 or (b) that respondent improperly calculated the California source income based on respondent's
28 allocation approach. Rather, appellants contend the income was royalty income and should be sourced entirely to Florida.
Accordingly, if the Board determines that the bonus income at issue was compensation income, and if appellants differ with
the method and manner in which respondent allocated such income within and without California under the workday
formula, appellants should be prepared to explain and defend their different allocation methodology.

1 California for 152 days in the last half of 2000 and of which 46 were in California. (Resp. Opening Br.,
2 p. 5)

3 In response to the Appeals Division staff's request for relevant federal case law
4 distinguishing between wage income and royalties, respondent states that federal case law often deals
5 with this distinction in the employment tax context. Respondent contends that many taxpayers attempt
6 to lower their tax burden by contending payments received are not wages for unemployment tax
7 purposes. Respondent notes that GKB did not seek to avoid these additional tax burdens, but appellants
8 are only seeking to avoid sourcing any of this income to California. Respondent also points to CCA
9 200305007, *supra*, as support for its position.¹⁰ Respondent contends that the CPA in that situation
10 entered into a license and royalty agreement with his employer which provided that his compensation
11 was for his client list and the mining and work related thereto. Respondent contends the IRS explained
12 that "the IRC and the regulations thereunder did not give weight to the name of the remuneration for
13 employment or the basis upon which the remuneration was measured." (Resp. Supp. Br., p. 2.)

14 Respondent asserts that two important points can be gleaned from CCA 200305007.
15 First, in every case at issue reviewed in the memorandum, the IRS was analyzing payments made under
16 a written agreement; and even then, it was most often found that payments were wages. Respondent
17 contends that in this case, there is no written agreement to even begin such an analysis. Second,
18 respondent contends that the IRS and courts have found royalties, especially when paid to an employee,
19 must be "passive" and thus cannot include compensation for services rendered by the owner of the
20 property (citing *Comm'r v. Affiliated Enterprises* (10th Cir. 1941) 123 F. 2d 665, cert. den. 315 U.S.
21 812.) In this appeal, respondent asserts, all the declarations confirm that appellant-husband performed
22 services in relation to each deal. (Resp. Supp. Br., p. 3.)

23 In response to Appeals Division staff's request for additional documentary evidence
24 supporting the parties' contentions, respondent provided appellants' 2000 federal and California tax
25 returns (which, as respondent argues above, support respondent's position), another declaration from
26 Keiffer Voss, Senior Vice President of GKB, and the contracts of purchase/bond agreements for four of
27

28 ¹⁰ Respondent also acknowledges that Chief Counsel Memoranda may not be cited as precedent.

1 the deals for which appellant-husband was paid. (Resp. Supp. Br., exh. B and exh. C.) Respondent
2 contends that none of these documents supports appellants' theory that the payments to appellant-
3 husband were for licensing intellectual property. (Resp. Supp. Br., p. 4.)

4 Applicable Law

5 R&TC section 17041 generally provides that the California taxable income of a
6 California nonresident includes gross income and deductions derived from California sources. R&TC
7 section 17951 provides that for nonresident taxpayers, gross income includes only the gross income
8 from sources within California." Regulation 17951-1, subdivision (a) provides that nonresidents are
9 taxable only upon taxable income derived from sources within this state. Regulation 17951-2 provides
10 that income from sources within California includes compensation for personal services performed in
11 California. (See also *Appeal of Robert C. and Marian Thomas*, 55-SBE-006, Apr. 20, 1955.)

12 R&TC section 17954 provides that for purposes of computing "taxable income of a
13 nonresident or part-year resident under paragraph (1) of subdivision (i) of Section 17041...gross income
14 from sources within and without this state shall be allocated and apportioned under rules and regulations
15 prescribed by the Franchise Tax Board." Regulation 17951-5 provides that nonresidents who performed
16 services both within and without California must allocate to California that portion of total
17 compensation reasonably attributed to sources within the state. A reasonable method of income
18 allocation is described in Regulation 17951-5, subdivision (b), which is a formula based on a ratio of the
19 number of working days in California to the number of working days both in and outside of California.

20 R&TC section 17952 provides that income from intangibles (such as royalty payments)
21 to a nonresident is not California source income, unless the intangible has acquired a business situs in
22 this state. The federal courts have defined a royalty as "a tax or duty or compensation paid to owners of
23 a patent or copyright for the use of it or the right to act under it." (*Comm'r v. Affiliated Enterprises*,
24 *supra*. at p.668.) Even though a royalty is ordinarily considered to be payment for patentable or
25 copyrightable property, the creative idea for which the royalty is paid need not be patented or
26 copyrighted. The determining factor as to whether a payment constitutes a royalty is the purpose for
27 which the payment is made. (*Id.*)

28 Respondent's determination of an assessment is presumed correct and appellant has the

1 burden of proving it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael E.*
2 *Myers*, 2001-SBE-001, May 31, 2001; *Appeal of Ismael R. Manriquez*, 79-SBE-077, Apr. 10, 1979.)

3 In *Sierra Club v. Comm’r*, *supra*, the Sierra Club, a tax-exempt nonprofit organization,
4 created mailing lists of its members and raised funds by “renting” these lists to other groups for a fee.
5 The Sierra Club also entered into an agreement with a credit card company whereby the company would
6 issue a card with the Sierra Club’s name and logo on the card and the Sierra Club agreed to cooperate
7 with the company to encourage its members to use the company’s services. In exchange, the Sierra
8 Club received a “royalty fee” based on a percentage of total cardholder sales volume. The IRS
9 determined that the income from the foregoing activities was unrelated business taxable income (UBTI)
10 but the U.S. Tax Court reversed the IRS’s determination, holding that the income constituted royalties
11 which are excludable from UBTI under IRC section 512(b). On appeal from the tax court, the Court of
12 Appeal affirmed and held that royalties are “payments for the right to use intangible property” which is
13 “by definition ‘passive’ and thus cannot include compensation for services rendered by the owner of the
14 property.” (*Id.* at 1532.)

15 The Court of Appeal found support for its distinction between payments for use of an
16 intangible property right and payments for services in an example provided in Revenue Ruling 81-178.
17 The example presents one scenario in which a tax-exempt professional athletic organization enters into
18 licensing agreements authorizing use of the organization’s trademarks, trade names, service marks,
19 members’ names, photographs, likenesses and facsimile signatures; under the terms of the agreements,
20 the organization had the right to approve the quality and style of the use of the licensed product. In the
21 second scenario, the same organization solicits and negotiates agreements to endorse products and
22 services offered by the other party to the agreement and the agreements required personal appearances
23 by the members of the organization. According to the revenue ruling, the first scenario is a royalty
24 arrangement within the meaning of IRC section 512(b) but the second scenario is not because the
25 agreements “require the personal services of the organization’s members in connection with the
26 endorsed products and services.” (*Id.* at 1533.)

27 Despite this distinction, the federal courts have held that the payee of a royalty may
28 perform some services in connection with its intangible property rights. The U.S. Tax Court, in

1 *Common Cause v. Commissioner* (1999) 112 T.C. 332, 342 (*Common Cause*), held that “the owner of an
2 intangible may engage in certain activities to exploit and protect the intangible which do not change the
3 nature of the payment received. . . . To hold otherwise, it seems to us, ‘would require us to hold that any
4 activity on the part of the owner of intangible property to obtain a royalty, renders the payment for the
5 use of that right UBTI and not a royalty.’” (*Id.* citing *Sierra Club, supra* at 1536.).

6 In that case, *Common Cause*, a tax-exempt nonprofit organization rented its mailing list
7 for a fee to third-parties through the medium of a broker. The tax court found the only activities in
8 which *Common Cause* directly engaged were review of the “data cards” that the broker used to promote
9 and advertise the rental list and approval of list rental transactions. The tax court found that those were
10 not “significant activities” and thus “[r]eview of promotional and advertising material by the owner of
11 an intangible is not inconsistent with royalty treatment.” The court also rejected the IRS’s contention
12 the list rental payments were not royalties because there was no written licensing agreement. The court
13 held the terms and conditions of each transaction between a third party and *Common Cause* by which
14 the third party had a one-time right to use the rental list information represented a separate licensing of
15 the list so the absence of a written licensing agreement did not prevent the list rental payment from being
16 a royalty.

17 This Board previously held that non-precedential decisions “are not citable authority and
18 will not be relied upon or given any consideration by this Board as precedent.” (*Appeals of Garrison*
19 *Hearst and Antonio Langham*, 2002-SBE-007, Nov. 13, 2002.)

20 STAFF COMMENTS

21 Both parties contend that the character of the payments as wage income or royalties
22 should be determined based on the totality of the evidence presented. As evidence that the payments
23 were wage income, respondent points to the Three Elements of Compensation showing that appellant-
24 husband was required to perform services in connection with each transaction. In addition, the Appeals
25 Division notes that appellants state appellant-husband’s “exact royalty percentage on any particular
26 Transaction was subject to negotiations with GKB and was relative to the amount of work he performed
27 for each particular Transaction.” (Appeal Ltr., p.3.) As the case law cited above indicates, in order for a
28 payment to be considered a royalty, the payment cannot include compensation for services rendered by

1 the owner of the property. In view of appellants' description of the negotiated royalty amounts, at the
2 hearing, appellants should be prepared to explain the extent to which the amounts of the payments were
3 based on the services performed by appellant-husband.

4 Should the Board find that the bonuses were payments for use of property (royalties), the
5 Board will need to determine whether appellant-husband's services in connection with the payments
6 prevent them from being considered royalties. Respondent suggests that if any part of the payments was
7 compensation for services, the payments could not be considered royalties. However, based on the
8 record presented, it appears to the Appeals Division staff that appellant-husband may have performed
9 relatively minimal services in connection with each transaction. At the hearing, the parties should be
10 prepared to discuss whether such services were "significant activities" that would be inconsistent with
11 royalty treatment for the entire amount of the payments. In this regard, appellants should be prepared to
12 present any more detailed evidence of appellant-husband's activities, if available.

13 In addition, when a portion of a payment is compensation for "significant activities" and
14 the other portion is for use of intangible property rights, it is not clear whether the entire amount of the
15 payment is disqualified as a royalty. At the hearing, the parties should be prepared to discuss whether
16 the payments may be apportioned between wage income and royalties assuming that the services
17 performed by appellant-husband were "significant activities."

18 While appellants dispute the taxation of the entire amount claimed as royalty income,
19 they have not addressed whether the working days formula applied by respondent properly apportions
20 appellant-husband's income to California in the event that the Board finds some or all of the amount is
21 wage income. If appellants do not believe the formula reflects proper apportionment, then appellants
22 should be prepared to discuss their position and advance an alternative reasonable method at the hearing.

23 **Issue 2: Whether the Board has jurisdiction to abate the post-amnesty penalty.**

24 Contentions

25 Although appellants do not expressly request abatement of the post-amnesty penalty,
26 respondent presumes that the appeal contests the entire proposed assessment affirmed by the NOA,
27 including the penalty. Respondent contends that this Board does not have jurisdiction to consider
28 abatement of the post-amnesty penalty until it has been assessed as a final liability and has been paid.

1 Applicable Law

2 In 2004, the Legislature enacted Senate Bill 1100 (Stats. 2004, Ch. 226) adding R&TC
3 sections 19730 through 19738, which set forth the provisions for the income tax amnesty program
4 whereby taxpayers who paid tax and interest liabilities were granted relief from most penalties,
5 including the penalty for late filing of the return. The tax amnesty program was conducted during a two-
6 month period from February 1, 2005, through March 31, 2005, inclusive and applied to tax liabilities for
7 taxable years beginning before January 1, 2003. (Rev. & Tax. Code, § 19731.)

8 For taxpayers who were eligible for the amnesty program but failed to participate, R&TC
9 section 19777.5, subdivision (a), imposes a penalty for each taxable year for which amnesty could have
10 been requested. R&TC section 19777.5 generally provides that the amnesty penalty will be imposed in
11 an amount equal to 50 percent of interest accrued on unpaid tax as of the last day of the amnesty period
12 (March 31, 2005). The amnesty penalty is imposed in addition to any other applicable penalties.

13 Under the statutory provisions, respondent has no discretion to determine whether the
14 amnesty penalty should be imposed. In addition, the amnesty provisions limit the Board's review of
15 respondent's imposition of the amnesty penalty. Subdivision (e)(2) of R&TC 19777.5 grants the Board
16 jurisdiction to review respondent's imposition of the amnesty penalty in a single circumstance: where a
17 taxpayer paid the amnesty penalty and filed a refund claim asserting that respondent failed to "properly
18 compute" the amount of the penalty which claim was denied by respondent.

19 STAFF COMMENTS

20 In general, the Board's authority to review respondent's final actions is based on R&TC
21 section 19045, which provides the Board with jurisdiction to review actions on a taxpayer's protest of an
22 unpaid assessment, and R&TC section 19324, which provides the Board with jurisdiction to review
23 action on a taxpayer's refund claim. However, with respect to the amnesty penalty, subdivision (d) of
24 R&TC section 19777.5 eliminates the first potential basis for jurisdiction under R&TC section 19045 to
25 review an action on a taxpayer's protest of unpaid assessments.

26 At the hearing, appellants should be prepared to explain why they believe this Board has
27 authority to abate the post-amnesty penalty in this appeal.

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