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2020 – OTA – 198P
Pending Precedential

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18073403
G. STABILE	)

OPINION

Representing the Parties:

For Appellant: G. Stabile

For Respondent: Mira Patel, Tax Counsel

For Office of Tax Appeals Andrew Jacobson, Tax Counsel III

C. AKIN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, G. Stabile (appellant) appeals an action by Franchise Tax Board (FTB) proposing additional tax of $3,173, plus applicable interest, for the 2012 tax year.

Appellant waived his right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUE

Whether appellant has established error in FTB's determination that a portion of the gross income from the vesting of long-term incentive plan mirror shares in 2012 was California source income.

FACTUAL FINDINGS

1. In 2007, appellant accepted an employment position in California with EDF Renewable Services (Renewable Services) located in North Palm Springs, California.
2. Appellant continued to work in California for Renewable Services until 2012 when he accepted a position with EDF Energy Renewables, a related company in London, United Kingdom (U.K.). Appellant's work assignment in the U.K. began on January 5, 2012, but appellant remained and worked in California periodically until April 1, 2012.

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3. On November 10, 2010, while appellant was still working for Renewable Services in North Palm Springs, California, the Board of Directors of enXco, an EDF EN Company,[1] voted to offer a Long-Term Incentive Plan (LTI) that granted mirror shares to key United States (U.S.) employees. A letter from enXco to appellant dated January 10, 2011, explains the award and vesting of appellant's LTI mirror shares. Appellant was awarded 1,000 mirror shares[2] as of November 10, 2010. Half of these units were to be paid on the first vesting date, on November 12, 2012, and the remaining units were to be paid on the second vesting date, on November 12, 2013. On each of these vesting dates, appellant was to be paid an amount in dollars based on the closing price of one EDF EN share on the vesting date times the number of mirror shares vesting on that vesting date. The vesting of the LTI mirror shares was subject to two conditions: (1) appellant's continued employment with the group at each vesting date, and (2) achievement of certain specified performance-related goals by EDF EN Group by the end of the 2011 financial year and by the end of September 2012.
4. Renewable Services paid appellant gross income of $73,455 upon the vesting of 500 LTI mirror shares in November 2012.[3]
5. A Form W-2, Wage and Tax Statement, issued to appellant by Renewable Services for the 2012 tax year reported federal (box 1) and California (box 16) "wages, tips and other compensation" of $127,224. This amount included the $73,455 LTI compensation paid to appellant upon the vesting of the mirror shares.
6. Appellant filed a California Resident Income Tax Return (Form 540) for the 2012 tax year reporting total tax (after an exemption credit) of $2,196. Appellant did not include the $73,455 LTI compensation in either his federal or California adjusted gross income (AGI).

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[1] While related, the precise business relationship between Renewable Services, EDF Energy Renewables, enXco, and EDF EN is not explained by either party.

[2] The enXco letter defines a mirror share as "a Unit that represents a right to receive the cash equivalent of the Market Value on the Vesting Date of one Share; subject to and in accordance with the terms of the Plan and the applicable Award Agreement."

[3] Based on the enXco letter, this amount represented the market value of the 500 mirror shares on the November 12, 2012 vesting date which was paid to appellant in cash rather than in actual shares of EDF EN stock.

7. The Internal Revenue Service (IRS) subsequently provided FTB with information that showed that on his 2012 federal tax return, appellant claimed a foreign earned income exclusion of $70,416 from his AGI under Internal Revenue Code (IRC) section 911.[4]
8. FTB commenced an audit of appellant's 2012 tax return.
9. In an undated letter to FTB, appellant asserted that he formally "broke" his U.S. residency with the U.S. Embassy on March 15, 2012. Appellant acknowledged that he had received LTI compensation of $73,455, but stated that the LTI mirror shares matured in October and November 2012 after he had ceased to be a California resident. Appellant asserted that these LTI mirror shares were not related to any work that he performed in California.
10. In an audit position letter dated June 21, 2017, FTB stated that it would accept appellant's assertion that he ceased to be a California resident on March 15, 2012, and that he was a part-year resident during 2012. With respect to the $73,455 LTI compensation paid to appellant upon the vesting of the 500 LTI mirror shares on November 12, 2012, FTB determined that this income was subject to California tax based on the number of working days in California versus the number of working days everywhere from the grant date to the vesting date. FTB found that there were 502 working days from November 10, 2010 (the grant date), through November 12, 2012 (the vesting date), and that appellant worked in California for 320 days during this 502 working-day period. Therefore, FTB calculated that appellant spent 63.7 percent of his working days in California during the vesting period (i.e., 320 ÷ 502 = 63.7 percent). Applying a California allocation ratio of 63.7 percent, FTB calculated that $46,791 of the $73,455 LTI compensation paid to appellant was subject to California tax (i.e., $73,455 x .637 = $46,791).
11. In response, appellant did not dispute FTB's California working-day allocation ratio. However, appellant contended that the LTI compensation was not subject to tax by California because the payment resulted from a sale of stock in France by his employer's

[4] The excluded income relates to the $73,455 of LTI compensation Renewable Services paid to appellant in November 2012. Neither party explains the discrepancy between the $73,455 paid to appellant and the $70,416 exclusion reflected in the information provided by the IRS. Additionally, a copy of appellant's 2012 federal return, which may reconcile this difference, is not in the record. In any event, since the parties treat the higher amount of $73,455 as being at issue in this appeal, we will do the same.

parent company and that it was "commensurate to continued employment in the EDF group during a 2/3 year term."[5]

12. FTB subsequently issued a Notice of Proposed Assessment (NPA) to appellant. In the NPA, FTB stated that based on the information appellant provided, FTB determined that appellant filed Form 540 (California Resident Income Tax Return) in error. The NPA explained that nonresidents and part-year residents are required to file Form 540NR (California Nonresident or Part-Year Resident Income Tax Return). The NPA increased appellant's California taxable income to include $46,791 of appellant's LTI compensation as California source income. The NPA proposed additional tax of $3,629, plus interest.
13. Appellant timely protested the NPA. Appellant argued that he received incentive stock options, which his employer labeled as LTI mirror shares. He stated that incentive stock options are not taxable under California law "if the sale or disposition of those stocks or incentives were made as a nonresident." Appellant asserted that his "foreign stocks matured" in November 2012 while he was a California nonresident and were sold shortly thereafter while he was still a nonresident. Appellant also indicated that the proposed assessment improperly excluded itemized deductions.
14. At protest, FTB reduced appellant's California taxable income in order to properly reflect appellant's California prorated itemized deductions rather than the standard deduction. On May 31, 2018, FTB issued a Notice of Action, revising the proposed additional tax from $3,629, as reflected on the NPA, to $3,173, plus applicable interest.
15. This timely appeal followed. In his reply brief, appellant argues for the first time that California is preempted from taxing his LTI compensation by the tax treaty between the U.S. and the U.K.

[5] Appellant also contended FTB failed to calculate a ratio for the second LTI period that vested in 2013, and that he would agree to a higher level of California taxation of his 2012 LTI compensation if California would lower its taxation of his LTI compensation for 2013, 2014, and 2015. However, the present appeal only concerns the LTI compensation paid to appellant in the 2012 tax year, and therefore we do not need to address appellant's contention for the 2013 tax year.

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DISCUSSION

California Taxation of Part-Year Residents and Income Tax Treatment of Appellant's LTI Compensation

California residents are taxed on their entire taxable income (regardless of source), while nonresidents are only taxed on income from California sources. (R&TC, §§ 17041(a), (b), & (i), 17951.) Part-year residents are taxed on their income (regardless of source) earned while residents of this state, as well as all income derived from California sources while nonresidents. (R&TC, § 17041(b) & (i).) Because appellant is undisputedly a part-year resident during the 2012 tax year, he is subject to California tax on all income (regardless of source) earned while a California resident from January 1, through March 14, 2012, and all income derived from California sources while a California nonresident from March 15, through December 31, 2012.

IRC section 83(a), which is incorporated into California law by R&TC section 17081, governs the taxation of property (such as appellant's LTI mirror shares) transferred in connection with the performance of services. Under IRC section 83(a), gross income for tax purposes includes income from such property, in the first tax year in which "the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier." (IRC, § 83(a)(1).) A substantial risk of forfeiture exists where the rights of a person in property are conditioned, directly or indirectly, upon the future performance of substantial services by any individual. (IRC, § 83(c)(1).) The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture. (IRC, §83(c)(2).)

Here, appellant's LTI mirror shares remained subject to a substantial risk of forfeiture until the stated vesting dates because the payment of the value of the mirror shares on the vesting date(s) was specifically conditioned on: (1) appellant's continued employment with the group at each vesting date, and (2) achievement of certain specified performance-related goals by EDF EN Group by the end of the 2011 financial year and by the end of September 2012. If one or both of these conditions is not satisfied (i.e., if appellant is no longer employed with the group on the vesting dates or EDF EN Group fails to achieve the specified performance-related goals by the dates specified), appellant would not have been entitled to any payment relating to his LTI mirror shares. Thus, appellant's LTI compensation remained subject to a substantial risk of

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forfeiture until the specified vesting dates and the income resulting from the vesting of 50 percent of appellant's LTI mirror shares on November 12, 2012, is properly recognized as income on November 12, 2012, when the shares vested and appellant was paid for the value of these shares by his employer.

Because appellant's mirror shares vested and the LTI compensation was paid to appellant after he became a California nonresident, this compensation will only be subject to California tax to the extent it is found to be derived from California sources. (R&TC, §17041(i)(1)(B).) California Code of Regulations, title 18, section (Regulation) 17951-2 provides that income from sources within California includes compensation for personal services performed within California. Here, the $73,455 LTI compensation paid to appellant upon the vesting of his mirror shares in November 2012 is properly treated as compensation for appellant's services. "When assets are transferred by an employer to an employee to secure better services they are plainly compensation. It makes no difference that the compensation is paid in stock rather than in money." (*Comm'r v. LoBue* (1956) 351 U.S. 243, 247 (*LoBue*).) It is undisputed that the LTI mirror shares were granted to appellant on November 10, 2010, while appellant was working for Renewable Services in California and that 50 percent of these LTI mirror shares vested on November 12, 2012, after appellant became a California nonresident. As the LTI compensation paid to appellant upon the vesting of these mirror shares in November 2012 is properly treated as compensation for appellant's services, and because appellant performed a portion of these services in California, we conclude a portion of this income is California source income.

While appellant acknowledged that the LTI compensation is property treated under federal law as "deferred compensation," he argues that "[FTB] has not provided any link between the services provided in California and the awarding of the [mirror shares]." Appellant further contends the vesting of the LTI compensation is neither linked to his individual performance nor to any California project for which he was involved and asserts that he was never an officer of his employer or in a position to affect the share price or the financial performance of a foreign company. We disagree.

The enXco Letter makes clear that the LTI plan "granting Mirror Shares to US employees" was "specifically designed for key employees" who "consistently and positively impact enXco's and subsequently EDF EN's success and growth" and that appellant was "selected as a key employee." This selection as a key employee was "[b]ased on feedback from

[appellant's] Manager, as well as the view of the Senior Management team." The awarding of the LTI mirror shares is linked to appellant's employment and services in California because the shares were granted by enXco to appellant while he was working for Renewable Services in North Palm Springs, California. Additionally, the vesting of the mirror shares was specifically related to and made contingent upon both appellant's continued employment with the group on the vesting dates and the achievement of specific performance-related goals by EDF EN Group on specified dates prior to the vesting of appellant's LTI mirror shares. The linking of the mirror shares to appellant's continued employment with the group and the group's achievement of specified performance-related goals establishes that LTI compensation paid upon vesting was in fact intended as compensation for appellant's services during the specified vesting period under the reasoning in *LoBue*, as it was intended to incentivize appellant and secure better services from appellant during that period. Thus, the LTI compensation paid to appellant in November 2012, constitutes compensation for appellant's services during the vesting period (i.e., from November 10, 2010, through November 12, 2012). It is linked to appellant's California services because a portion of appellant's services provided during the vesting period were performed in California.

Accordingly, we conclude appellant's LTI compensation constitutes gross income from services performed, in part, in California. The next issue we address is what portion of the total LTI compensation of $73,455 is properly treated as California source income as a result.

Computation of Appellant's California Source Income

Gross income of nonresidents and part-year residents from sources within and without California "shall be allocated and apportioned under the rules and regulations prescribed by [FTB]." (R&TC, § 17954.) Regulation 17951-5(b) provides that "[i]f the employees are paid on 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."[6]

[6]Regulation 17951-5(b) also provides that "[i]f nonresident employees are employed in this State at intervals throughout the year . . . between this State and other states and foreign countries, and are paid on a daily, weekly or monthly basis, the gross income from sources within this State includes that portion of the total compensation for personal services which the total number of working days employed within the State bears to the total number or working days both within and without the State." However, we conclude that this portion of

FTB's determination is presumed to be correct, and a taxpayer has the burden of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Brockett* (86-SBE-109) 1986 WL 22731.) What constitutes a reasonable allocation method so as to properly limit a taxpayer's gross income to that earned from California sources must be based upon the facts and circumstances of each case. (See, e.g., *Appeal of Pesiri* (89-SBE-027) 1989 WL 129195.) "The critical factor which determines the source of income from personal services is not the residence of the taxpayer, or the place where the contract for services is entered into, or the place of payment. It is the place where the services are actually performed." (*Appeal of Spiegel* (86-SBE-121) 1986 WL 22743.)

California has long employed working-day, duty-day, or similar formulas to allocate income of nonresidents or part-year residents between (or among) California and other jurisdictions. For example, in *Newman et al. v. Franchise Tax Bd.* (1989) 208 Cal.App.3d 972, a nonresident taxpayer working under a movie contract to star in the motion picture, *The Sting,* received compensation for a total period of 54 days, which included days that he was working on the set, as well as days when he was on call for possible filming. The taxpayer spent some of those days traveling, filming, or on call outside California. On his 1975 return, the taxpayer computed his income from *The Sting* using a denominator of 30 days and a numerator of 25 days of filming in California. For 1976 and 1977, the taxpayer allocated *The Sting* income using a numerator of 30 days in California and a denominator of 54 total contract days. FTB rejected the taxpayer's allocation method. Instead, FTB excluded all travel days and on-call days and included only the days on which the taxpayer was called to work for actual filming. FTB found that during 1975, the taxpayer worked 27 total days of filming, 25 in California and two in Chicago, Illinois. Therefore, FTB determined that 92.59 percent (25 ÷ 27 = 92.59 percent) of the taxpayer's gross income in 1975 from *The Sting* should be allocated to California. (*Id.* at p. 975.) FTB applied the 92.59 percent allocation to the 1976 and 1977 tax years as well. Applying Regulation 17951-5(b), the Court of Appeal found that the taxpayer's allocation formula was correct, because he applied the proper definition of "working days," referred to by the contract as "duty days," "under the terms of which he was exclusive to this employer and 'on call' at the employer's complete discretion." (*Id.* at pp. 978-979.)

Regulation 17951-5(b) is not directly applicable to appellant's LTI compensation as the LTI compensation was paid in a lump sum on the vesting date rather than on a daily, weekly, or monthly basis.

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Similarly, in *Appeal of Spiegel*, *supra*, the BOE, pursuant to Regulation 17951-5(b), crafted an equitable solution using a working-day allocation formula to allocate compensation of $500,000 when the contract language was ambiguous. After concluding the $500,000 fee applied to the entire two-year period between the contract date and work completion date, the BOE found the taxpayer had worked 120 days in California and 264 days outside of California during this period, and allocated 31.2 percent of the fee to California as California source income (i.e., 120 ÷ 384 = 31.2 percent).

Here, FTB's allocation method, using working days from the grant date to the vesting date of the LTI mirror shares, is a reasonable allocation formula to determine appellant's California source income under the facts of this case. Specifically, FTB's allocation method is consistent with the mandate of Regulation 17951-5(b), which requires an individual's compensation for personal services to be apportioned "in such a manner as to allocate to California that portion of the total compensation which is reasonably attributable to personal services in this State." During the 502 working-day period from November 10, 2010, through November 12, 2012, appellant worked in California for 320 days. Therefore, FTB determined that appellant spent 63.7 percent of his working days during the vesting period in California (i.e., 320 ÷ 502 = 63.7 percent). As noted above, working-day calculations are a standard methodology for prorating the income of nonresidents and part-year residents and have been repeatedly found to be reasonable by the courts and the BOE. (*Newman et al. v. Franchise Tax Bd., supra*; *Appeal of Spiegel, supra*.)

Although appellant concedes that FTB's work-day calculation is correct, he asserts that California cannot tax his LTI compensation because he was not a California resident at the time that the LTI mirror shares vested and the LTI compensation was paid. Here, we note that appellant's situation is similar to *Appeal of Perelle* (58-SBE-057) 1958 WL 1283 (*Perelle*). In *Perelle,* the taxpayer was a California resident when he entered into an employment contact with a California employer in 1944. Under the employment contract, the taxpayer agreed to work exclusively for the employer for a period of five years. Later that same year, the taxpayer received a five-year option to purchase 10,000 shares of stock from his California employer. However, in December 1945, the taxpayer ceased to work for the employer and in 1946, the taxpayer was hired by a Michigan employer and moved to Michigan. After the taxpayer moved to Michigan, he sold his stock option back to his previous employer in California. The

California employer treated this payment as compensation on its books. Relying on the U.S. Supreme Court's decision in *LoBue*, *supra*, the BOE held that the gain on the sale of the option was compensation for services. Because the services were performed in California, the BOE concluded that the gain was taxable by California, despite the taxpayer's status as a Michigan resident at the time he sold the option back to the corporation.

While appellant had mirror shares that vested, rather than stock options that he sold, the sourcing of the income is the same as in *Perelle*. enXco granted appellant the LTI mirror shares on November 10, 2010, when appellant was a California resident. Appellant worked in California for Renewable Services (an enXco affiliate) for 320 days, ceased to be a California resident on March 15, 2012, and was paid $73,455 upon the vesting of his LTI mirror shares in November 2012, which appellant's employer, Renewable Services, treated as wage compensation. Again, because the payment upon the vesting of appellant's LTI mirror shares is properly treated as compensation for services and a portion of appellant's services during the vesting period was performed in California, FTB properly allocated a portion of appellant's LTI compensation to California as California source income.[7]

Contrary to appellant's contention, there is no requirement that a taxpayer must be a California resident on the vesting date of LTI mirror shares. Instead, as previously discussed, the LTI compensation represents income earned from the performance of personal services, and because appellant earned the income in 2012 from personal services he performed in California, he had California source income. (*Appeal of Bernhardt* (84-SBE-183) 1984 WL 16236; *Appeal of Rule* (76-SBE-099) 1976 WL 4115.) Appellant has not provided an alternative method for allocating a portion of his LTI compensation to California. Nor has appellant argued or produced evidence to show that the result reached by FTB, based on working days in California versus working days everywhere, is unreasonable or fails to properly allocate to California that portion of the LTI compensation which is reasonably attributable to his personal services in California, as required by Regulation 17951-5(b).

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[7] Appellant also argues that "[FTB] has not established why the sale of a foreign stock by a foreign entity should be considered CA source income." First, this argument misconstrues the nature of appellant's LTI mirror shares, as appellant was not awarded shares of stock in a foreign corporation that he or the corporation sold on a foreign exchange. Rather, appellant was paid an amount in U.S. dollars based on the market price of EDF EN stock on the specified vesting date. Second, even if appellant had been paid in shares of stock rather than in cash, based on *LoBue* and for the reasons discussed in this opinion, this payment (regardless of its form) is properly treated as compensation for services.

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Appellant also contends that "[FTB] accepted payment based on the vesting and not allocation of [mirror shares] in 2010, 2011, 2013, 2014, and 2015." However, the present appeal only concerns the LTI compensation paid to appellant in the 2012 tax year. Additionally, if appellant was a California resident during these other tax years, appellant would have been taxed on the entire amount paid in these years because California taxes residents on their entire taxable income (regardless of source). (R&TC, §§ 17041(a).)

Appellant further asserts that the increased value of the LTI mirror shares between March 15, 2012, and November 12, 2012, is not taxable. Appellant appears to misunderstand IRC section 83(a), which provides that a taxpayer is taxed precisely on the fair market value on the vesting date less any consideration paid for the stock. Because appellant has not shown that he paid any consideration for his LTI mirror shares, the entire $73,455 LTI compensation Renewable Services paid to him upon the vesting of these mirror shares in 2012 is gross income in this year. Additionally, of this amount, FTB only included $46,791 (i.e., 63.7 percent) in appellant's California taxable income as California source income.[8]

Therefore, we find that appellant has failed to show that FTB's allocation of his LTI compensation based on California working days versus working days everywhere during the vesting period produces an unreasonable result or fails to properly allocate to California that portion of appellant's LTI compensation which is reasonably attributable to appellant's personal services in California, as required by Regulation 17951-5(b). As such, appellant has not met his burden of proving error in FTB's determination. (*Todd v. McColgan, supra*; *Appeal of Brockett, supra.*)

Applicability of International Tax Treaty

Lastly, appellant argues that the U.S.-U.K. Tax Treaty prohibits all taxes on income and capital gains, including California income taxes. He asserts that the treaty does not expressly contain any applicable exceptions, and that the treaty simply states that it covers amounts that are taxed federally by the IRS.

However, appellant's contention is incorrect. The U.S. Supreme Court has held that tax treaties entered into by the U.S. do not generally prohibit the taxing activities of sub-national

[8] Appellant also asserts that the Chief Counsel Rulings cited by FTB do not apply. Because Chief Counsel Rulings are limited in scope to the taxpayer named in the ruling, we do not consider or place weight on them in this opinion.

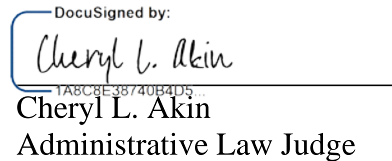
governments, such as states. (See *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 196.) The BOE has also declined to read any restrictions on California's ability to assess tax based on treaties between the U.S. and foreign countries when those treaties refer only to federal, not California, income taxes. (See *Appeal of de Mey van Streefkerk* (85-SBE-135) 1985 WL 15915.) Here, there is no language in the U.S.-U.K. Tax Treaty that provides that the terms of the treaty preempt state income taxes. Because the U.S.-U.K. Tax Treaty does not cover state income taxes, appellant's LTI compensation, as concluded above, is subject to taxation by California.

HOLDING

Appellant has failed to establish error in FTB's determination that he earned California source income from the vesting of his LTI mirror shares in 2012.

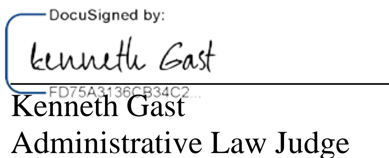
DISPOSITION

FTB's action is sustained.

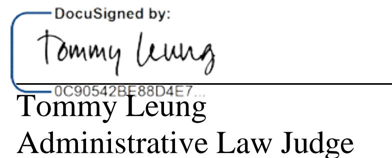


Cheryl L. Akin
Administrative Law Judge

We concur:



Kenneth Gast
Administrative Law Judge



Tommy Leung
Administrative Law Judge

Date Issued: 4/28/2020