OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **C. HALL AND** **M. HALL**	OTA Case No. 220911257

OPINION

Representing the Parties:

For Appellants: Michael C. Cohen, Attorney

For Respondent: Christopher M. Cook, Attorney

For Office of Tax Appeals: Oliver Pfost, Attorney

T. LEUNG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) sections 19335 and 19045, C. Hall and M. Hall (appellants) appeal an action by the Franchise Tax Board (respondent) proposing additional tax of $674,452 and applicable interest for the 2014 taxable year.

This appeal was originally scheduled for an oral hearing before the Office of Tax Appeals (OTA). However, when appellants did not reply to OTA's hearing notice, this matter was decided based on the written record.

ISSUE

Whether the income recognized by appellants from the exercise of nonqualified stock options (NSOs) and the vesting of restricted stock units (RSUs) in the 2014 taxable year is California source income.

FACTUAL FINDINGS

1. Appellants were residents of California during the period between 2009 and 2013. Appellants were residents of Hawaii in 2014.
2. Appellant M. Hall was president of Monster Beverage Company (MBC) between 2007 and 2013, and chief brand officer of MBC in 2014. Appellant M. Hall worked

predominantly at MBC's headquarters in Corona, California, until his move to Hawaii in December 2013.

3. MBC granted appellant M. Hall NSOs for MBC stock in December 2009, December 2010, and March 2013. Appellant M. Hall exercised the NSOs in September 2014.
4. MBC granted appellant M. Hall RSUs of MBC stock in September 2011. The RSUs vested in September 2014.
5. Appellants filed a 2014 California nonresident income tax return (Form 540 NR). Appellants reported that none of the income recognized from the exercised NSOs and vested RSUs was California source income.
6. In or around August 2018, respondent commenced an examination of appellants' 2014 Form 540 NR, specifically focusing on whether the income recognized from the exercised NSOs and vested RSUs was California source income.
7. On March 28, 2019, appellants signed a waiver to extend the statute of limitations for respondent to issue a proposed assessment for the 2014 taxable year to April 15, 2020.
8. Respondent issued an Audit Issue Presentation Sheet (AIPS) in March 2019 containing its determination that the exercised NSOs and vested RSUs were California source income because they were attributable to personal services performed by appellant M. Hall in California. Using a ratio of California working days to total working days, respondent determined the following:
    - 85.85 percent of the income recognized from the exercise of the NSO granted in December 2009 was California source income.
    - 82.08 percent of the income recognized from the exercise of the NSO granted in December 2010 was California source income.
    - 54.32 percent of the income recognized from the exercise of the NSOs granted in March 2013 was California source income.
    - 77.56 percent of the income recognized from the vesting of the RSUs granted in September 2011 was California source income.

9. After this determination, respondent reduced the number of California working days based on additional evidence submitted by appellants and issued a Notice of Proposed assessment (NPA) accordingly. The original determination computed a California revised adjusted gross income (AGI) of $7.2 million, while the NPA computed a lower California revised AGI of $5.2 million. The NPA proposed additional tax of $674,452, plus applicable interest.
10. Respondent issued a Notice of Action affirming its NPA.
11. While this appeal was pending, appellants made a payment of the additional tax of $674,452, plus applicable interest.

DISCUSSION

Taxation of NSOs and RSUs

When property is transferred to a person in connection with the performance of services, the excess of the fair market value of the property over the amount, if any, paid for the property is included in the gross income (i.e., income recognition for tax purposes) of the person performing the services in the first taxable year in which the rights of the person having the beneficial interest in the property are transferable or are not subject to substantial risk of forfeiture, whichever occurs earlier. (Internal Revenue Code (IRC), § 83(a); R&TC, § 17081.) NSOs and RSUs are property within the meaning of IRC section 83, and the income earned from the exercise of NSOs and the vesting of RSUs is treated as compensation for services. (Treas. Reg. § 1.83-7(a); R&TC, § 17024.5(d); see *Appeal of Stabile*, 2020-OTA-198P, citing *Commissioner v. LoBue* (1956) 351 U.S. 243, 247.) If an NSO does not have a readily ascertainable fair market value at the time the option is granted, the grantee recognizes the income in the taxable year the option is exercised. (Treas. Reg. § 1.83-7(a); *Appeals of Cremel and Koppel*, 2021-OTA-222P.) Likewise, a grantee generally recognizes taxable income on RSUs in the taxable year the RSUs vest, rather than in the taxable year they are granted. (*Appeals of Cremel and Koppel*, *supra*.)

MBC granted appellant M. Hall NSOs for MBC stock in December 2009, December 2010, and March 2013, which appellant M. Hall later exercised in September 2014. Additionally, MBC granted appellant M. Hall RSUs of MBC stock in September 2011 and the RSUs likewise vested in September 2014. There is no dispute whether appellants recognized

income from the exercise of the NSOs or the vesting of the RSUs. For example, appellants reported the income from these transactions on their 2014 Form 540 NR. Rather, appellants contend the income realized from the NSOs and RSUs is not subject to California's personal income tax because they were nonresidents of California at the time the NSOs were exercised and the RSUs vested.

Sourcing the NSOs and RSUs

California residents are taxed on their entire taxable income, regardless of source, while nonresidents are only taxed on income derived from California sources. (R&TC, §§ 17041(a), (b), & (i); 17951.) Appellants were residents of California during the period between 2009 and 2013 and residents of Hawaii in 2014. Accordingly, the income appellants recognized in 2014 is subject to California's personal income tax only to the extent the income was derived from California sources.

Income derived from sources within California includes compensation for personal services if California is the location where the services were actually performed. (Cal. Code Regs., tit. 18, § 17951-2; *Appeal of Stabile*, *supra*, citing *Appeal of Spiegel* (86-SBE-121) 1986 WL 22743.) Compensation for personal services must be apportioned between California and other states in such a manner as to allocate to California that portion of the total compensation which is reasonably attributable to personal services in California. (Cal. Code Regs., tit. 18, § 17951-5(b); *Appeal of Stabile, supra*.) What constitutes a reasonable allocation method that properly limits a taxpayer's gross income to that earned from California sources must be based on the facts and circumstances of each case. (*Appeal of Stabile, supra*.) California has long employed working-day, duty-day, or similar formulas to allocate income of nonresidents between California and other jurisdictions. (*Ibid*.) 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. (*Ibid*.) When a California nonresident recognizes income from the exercise of an NSO or the vesting of an RSU, the income is derived from sources within California if the NSO or RSU is compensation for personal services performed in California. (See *ibid*., citing *Appeal of Perelle* (58-SBE-057) 1958 WL 1283.)

Respondent determined the exercised NSOs and vested RSUs were California source income because they were attributable to personal services performed by appellant M. Hall in California. In allocating the income recognized from the NSOs and RSUs, respondent used a

ratio of California working days to total working days, which is a standard methodology for prorating income. (*Appeal of Stabile, supra*.) Appellants have not argued or otherwise shown this calculation to be incorrect.

Appellants argue California's treatment of appellant M. Hall's income related to the NSOs and RSUs is improper because it applies the accrual method of accounting to appellants, who are cash basis taxpayers. Appellants contend the United States Supreme Court has stated that the income tax applies to all undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion, citing *Commissioner v. Glenshaw Glass* (1955) 348 U.S. 426. Appellants argue they did not have an accession to wealth, clearly realized until after they became residents of Hawaii in 2014. In other words, appellants appear to be arguing, as a matter of law and not of fact, that none of the income recognized from the NSOs and RSUs is taxable by California because they were not residents of California when the NSOs were exercised and the RSUs vested.

Appellants' argument is misplaced. Compensation for personal services performed in California by a nonresident is income derived from sources within California and thus subject to California's personal income tax. (R&TC, §§ 17041(i); Cal. Code Regs., tit. 18, § 17951-2.) It is immaterial that appellants ceased being residents of California in 2014 when the income from the NSOs and RSUs was recognized because the income from the NSOs and RSUs is treated as compensation for personal services appellant M. Hall performed in California during the period of his California residency between 2009 and 2013. The income from the NSOs and RSUs is, therefore, California source income.

Due Process

Alternatively, appellants contend respondent issued its determination in this matter after the statute of limitations to file a claim for refund in Hawaii had expired, and respondent has unfairly precluded appellants from claiming in Hawaii a tax credit for the tax that respondent claims to be due in California. For this reason, appellants argue respondent denied them procedural and substantive due process, and respondent's action is unconstitutional.

As a general rule, OTA's jurisdiction is limited to determining the correct amount of a taxpayer's California personal income tax liability. (See *Appeals of Dauberger, et al.* (82-SBE-082) 1982 WL 11759.) OTA does not have jurisdiction to determine whether taxpayers are entitled to a remedy for respondent's actual or alleged violation of any substantive or

procedural right to due process under the law, unless the violation affects the adequacy of a notice, the validity of an action from which a timely appeal was made, or the amount at issue in the appeal. (Cal. Code Regs., tit. 18, § 30104(d).)[1] OTA therefore lacks jurisdiction over the issue of whether respondent denied appellants due process under the law, and OTA cannot reverse or make discretionary adjustments to respondent's determination solely on that basis.

HOLDING

The income recognized by appellants from the exercised NSOs and the vested RSUs in the 2014 taxable year is California source income.

DISPOSITION

Respondent's action is sustained.

DocuSigned by:
Tommy Leung
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Tommy Leung
Administrative Law Judge

We concur:

Signed by:
Veronica I. Long
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Veronica I. Long
Administrative Law Judge

DocuSigned by:
Keith T. Long
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Keith T. Long
Administrative Law Judge

Date Issued: 12/13/2024

[1] Appellants filed this appeal in August 2022, so OTA's Rules for Tax Appeals effective March 1, 2021, through June 29, 2023, apply.