OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of:	) OTA Case Nos. 18042625 & 20076340
O. CREMEL AND	)
E. KOEPPEL	)
	)
	)

OPINION

Representing the Parties:

For Appellants:	Gregory R. Wilson, Attorney
For Respondent:	Bradley J. Coutinho, Tax Counsel III Ellen L. Swain, Tax Counsel IV
For Office of Tax Appeals:	Andrew Jacobson, Tax Counsel III

C. AKIN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19331, O. Cremel and E. Koeppel (respectively, appellant Cremel and appellant Koeppel; collectively, appellants) appeal respondent Franchise Tax Board's (FTB) deemed denial of appellants' claim for refund of $214,815, plus applicable interest, for the 2011 tax year. Pursuant to R&TC section 19045, appellant Koeppel also appeals an action by FTB proposing $145,062 of additional tax and a late-filing penalty of $36,265.50, plus applicable interest, for the 2012 tax year.

Office of Tax Appeals Administrative Law Judges Huy "Mike" Le, Josh Lambert, and Cheryl L. Akin held an oral hearing for this matter on January 26, 2021.[1] At the conclusion of the oral hearing, we held the record open until March 1, 2021, to allow for additional briefing on the sourcing issue. Thereafter, we closed the record, and this matter was submitted for decision.

ISSUES

1. Whether appellant Koeppel's community property interest in the income earned during the 2011 and 2012 tax years from nonqualified stock options (NQSOs) and restricted

[1] The oral hearing was noticed for Sacramento, California, and conducted electronically due to COVID-19.

stock units (RSUs) granted to appellant Cremel is California source income.

2. Whether FTB's proposed assessment issued to appellant Koeppel for the 2012 tax year is barred by the statute of limitations.
3. Whether the late-filing penalty was properly imposed with respect to appellant Koeppel's 2012 tax year.

FACTUAL FINDINGS

Background

1. Appellants were married from September 15, 1997, until May 14, 2012.
2. Appellant Cremel moved from France to California in 1996 and appellant Koeppel moved from France to California in 1998.
3. Appellant Koeppel moved back to France in July 2008, and has been a nonresident of California since July 2008.
4. Appellant Cremel began working for VMware, Inc. (VMware) in California in 2001. While married to appellant Koeppel, appellant Cremel was granted certain NQSOs and RSUs by his employer, VMware (collectively, VMware Equity) as part of his compensation.
5. The VMware Equity was granted, vested, and exercised (as applicable) while appellants were married.
6. Appellant Cremel performed all of his services for VMware in California.
7. All of the VMware Equity income was earned during a period when appellant Cremel was domiciled in California.

2011 Tax Year

8. During 2011, a portion of the VMware Equity vested and was exercised by appellant Cremel, resulting in wage income of $4,171,164. The parties have stipulated that the $4,171,164 VMware Equity income earned in 2011 was community income and appellant Cremel remitted one-half of the proceeds to appellant Koeppel as her share of the community income.
9. Appellant Koeppel's community property share of the VMware Equity income earned in 2011 was $2,085,582 (i.e., 50 percent of $4,171,164).

10. Appellants timely filed a 2011 joint California Resident Income Tax Return (Form 540), which included the entire $4,171,164 VMware Equity income earned in 2011 as California taxable income.[2]

11. Appellants subsequently filed an amended 2011 joint return (Form 540X), excluding the entirety of appellant Koeppel's $2,085,582 community property share of the VMware Equity income from appellants' California taxable income and requesting a refund of $214,815.[3]

12. Because FTB did not act on appellants' claim for refund within six months following the filing of the claim (by issuing a refund or denying appellants' claim), appellants deemed their refund claim to have been denied and this timely appeal followed.

2012 Tax Year

13. During 2012, the remaining portion of VMware Equity vested and was exercised by appellant Cremel, resulting in wage income of $2,682,970. The parties have stipulated that the $2,682,970 VMware Equity income earned in 2012 was community income and appellant Cremel remitted one-half of the proceeds to appellant Koeppel as her share of the community income.

14. Appellant Koeppel's community property share of the VMware Equity income in 2012 was $1,343,351.[4]

15. Appellant Cremel timely filed a 2012 Form 540 in April 2013.[5] On this return, appellant Cremel reported a California subtraction of $1,343,351 to exclude appellant Koeppel's

[2] Because appellant Koeppel was a nonresident of California during 2011, appellants should have filed a California Nonresident Income Tax Return (Form 540NR) rather than a Form 540, resident return, for the 2011 tax year. We simply note this filing error, as it does not impact our conclusions.

[3] On appeal, appellants concede that $324,538 of appellant Koeppel's $2,085,582 community property share of the VMWare Equity income earned in 2011 is California source income and should have been included on the 2011 Form 540X.

[4] It is unclear why this amount is slightly more than one-half of the $2,682,970 of VMware Equity income earned during 2012 ($2,682,970 x 0.50 = $1,341,485, not $1,343,351); however, the parties have stipulated that appellant Koeppel's community share of the VMware Equity income in 2012 was $1,343,351.

[5] Because appellants divorced May 14, 2012, appellant Cremel did not file a joint 2012 California Resident Income Tax Return with appellant Koeppel. Rather, appellant Cremel filed a joint 2012 California Resident Income Tax Return with his new spouse.

community property share of the VMware Equity income from appellant Cremel's California taxable income for the 2012 tax year.[6]

16. Appellant Koeppel did not initially file a return in California for the 2012 tax year.

17. Because FTB determined that appellant Koeppel received sufficient California source income to require the filing of a California tax return, on June 5, 2019, FTB issued a Demand for Tax Return to appellant Koeppel for the 2012 tax year.

18. On June 30, 2019, appellant Koeppel filed an untimely 2012 Form 540NR, nonresident return, reporting her community property share of the 2012 VMware Equity income as non-California source income. As a result, appellant Koeppel reported $0 California taxable income and $0 California tax for the 2012 tax year.

19. On February 20, 2020, FTB issued a Notice of Proposed Assessment (NPA) to include appellant Koeppel's community property share of the 2012 VMware Equity income as California source income.[7] This NPA proposed additional tax of $145,062 and imposed a late-filing penalty of $36,265.50.

20. Appellant Koeppel timely protested the NPA, and FTB issued a Notice of Action affirming the NPA.

21. This timely appeal by appellant Koeppel followed, which was consolidated with appellants' appeal for the 2011 tax year.

DISCUSSION

Issue 1: Whether appellant Koeppel's community property interest in the income earned during the 2011 and 2012 tax years from NQSOs and RSUs granted to appellant Cremel is California source income.

Taxation of California Residents and Nonresidents Generally

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) &

[6] The parties have stipulated that this Form 540 disclosed the exclusion of appellant Koeppel's community property share of the VMware Equity income and the basis for such exclusion. FTB is not challenging this subtraction from appellant Cremel's return and this subtraction is not at issue in this consolidated appeal.

[7] The NPA included "wage income" of $1,266,551 as California source income. It is unclear why this amount differs from appellant Koeppel's $1,343,351 community property share of the VMware Equity income.

(i), 17951.) Because appellant Cremel was a California resident for the 2011 tax year, appellant Cremel is taxed on all of his income, regardless of the source of that income.[8] Because appellant Koeppel was a nonresident for the 2011 and 2012 tax years, appellant Koeppel will only be taxed on her California source income earned during the 2011 and 2012 tax years.

Two-Step Analysis

At issue here is whether California can tax appellant Koeppel's community property share of the VMware Equity income of $4,171,164 and $2,682,970 earned during the 2011 and 2012 tax years, respectively. In situations such as this, where one spouse is a resident of California and the other spouse is a nonresident of California, the determination of whether an item of income is taxable in California to the nonearning spouse can be broken down into a two-step analysis, as discussed in detail below. The first step requires a determination of the nonearning spouse's marital property interest in the earning spouse's income. If the nonearning spouse has a marital property interest in the earning spouse's income, the second step requires a determination of whether the nonearning spouse's interest in such income is taxable in California. The nonearning spouse's marital property interest in the income may be taxable in California either because the nonearning spouse is a resident of California who is taxed on all income regardless of source (R&TC, § 17041(a)), or because the nonearning spouse is a nonresident, but the income is California source income (R&TC, §§ 17041(b) & (i) and 17951). The source of the income in the hands of a nonearning, nonresident spouse is determined by applying California's nonresident sourcing rules to the facts surrounding how the income was generated as if the nonearning, nonresident spouse had derived the income directly from the source from which the earning spouse derived it.

Step 1: Determination of Appellant Koeppel's Martial Property Interest in the VMware Equity Income.

An individual's marital property interest in personal property is determined by the laws of the earning or acquiring spouse's domicile. (*Appeal of Li*, 2020-OTA-095P (*Li*), citing *Schecter v. Superior Court* (1957) 49 Cal.2d 3, 10 and *Rozan v. Rozan* (1957) 49 Cal.2d 322, 326.) Because appellant Cremel is the earning spouse of the VMware Equity income, and appellant Cremel was a resident and domiciliary of California when that income was earned,

[8] Appellant Cremel's 2012 tax year is not at issue in this appeal.

California law will apply for purposes of determining appellant Koeppel's marital property interest in the income. California Family Code section 760 provides that, generally, all property, real or personal, wherever situated, acquired by a married person during the marriage while domiciled in California is community property.

The parties have stipulated that the VMware Equity was granted, vested, and exercised while appellants were married and that the VMware Equity income was earned when appellant Cremel was domiciled in California. Thus, the parties agree that the VMware Equity income earned in 2011 and 2012 is community income and appellant Koeppel's community property interest in the income earned during 2011 and 2012 is $2,085,582 and $1,343,351, respectively.

Where the income in question is community property, one-half of the income is attributable to each spouse and each spouse must report and pay tax on his or her respective one-half community property interest in the income. (See *United States v. Mitchell* (1971) 403 U.S. 190 (*Mitchell*); *United States v. Malcom* (1931) 282 U.S. 792 (*Malcom*); *Poe v. Seaborn* (1930) 282 U.S. 101.) Because one-half of the community income is attributable to appellant Koeppel for income tax reporting purposes and because appellant Koeppel was a nonresident, under step two of the analysis, appellant Koeppel's one-half community property share of the VMware equity income will only be included in appellants' joint California taxable income in 2011 and appellant Koeppel's separate California taxable income in 2012, if the income is California source income.

Step 2: Determination of Whether Appellant Koeppel's Community Property Interest in the VMware Equity Income is California Source Income.

Appellants contend that appellant Koeppel's one-half community property share of the VMware Equity income is not California source income because appellant Koeppel was a nonresident of California during the time this income was earned and, thus, she performed all of her services for the community in France, not California. FTB contends that because this income is compensation for appellant Cremel's services and appellant Cremel provided all of his employment-related services in California, this income is California source income to appellant Koeppel and therefore includible in appellants' joint California taxable income in 2011 and appellant Koeppel's separate California taxable income in 2012.

Taxation of NQSOs and RSUs under IRC section 83

For the 2011 and 2012 tax years, California conformed to Internal Revenue Code (IRC) section 83(a), as in effect on January 1, 2009. (R&TC, §§ 17081, 17024.5(a)(1)(O).) IRC section 83(a) provides rules for when property is transferred to a person "in connection with the performance of services." (See also Treas. Reg. § 1.83-3(f).) In general, IRC section 83(a) provides that 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 of the person performing the services in the first tax year in which the rights of the person having the beneficial interest in the property are transferable or not subject to a substantial risk of forfeiture, whichever is applicable.

Treasury Regulation section 1.83-7(a) provides that IRC section 83(a) applies to NQSOs. If the NQSOs do not have a readily ascertainable fair market value at the time the option is *granted*, the employee recognizes income at the time the option is *exercised*. (Treas. Reg. section 1.83-7(a); see also *Hann v. United States* (2017) 133 Fed. Cl. 559, 565.) For the tax years at issue here, IRC section 83(a) also governed the taxation of RSUs.[9] Pursuant to IRC section 83(a), an employee generally recognizes taxable income on RSUs when they are *vested*, rather than when they are *granted*. (*Appeal of Stabile*, 2020-OTA-198P (*Stabile*).) The income earned upon the exercise and vesting of such NQSOs and RSUs is treated as compensation for services. (*Ibid.*, citing *Commissioner v. LoBue* (1956) 351 U.S. 243, 247.)

Sourcing of Income Paid as Compensation for Services

Income from sources within this state includes compensation for personal services performed within this state. (Cal. Code Regs., tit. 18, § 17951-5.) Compensation for personal services, such as the VMware Equity income at issue here, "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." (Cal. Code Regs., tit. 18, § 17951-5(b).) "The critical factor which determines the source of income from personal services is not the residence of the taxpayer, or the place where

[9] P.L. 115-97, section 13603(a), amended IRC section 83 by adding subsection (i), effective for stock attributable to options exercised, or restricted stock units settled, after December 31, 2017. IRC section 83(i)(7) provides that IRC section 83 "shall not apply to restricted stock units." But this amendment is not applicable to the tax years on appeal here.

the contract for services is entered into, or the place of payment. It is the place where the services are actually performed." (*Stabile*, *supra*, citing *Appeal of Spiegel* (86-SBE-121) 1986 WL 22743.)

Here, it is undisputed that appellant Cremel was continuously employed in California during all relevant periods and performed all of his employment-related services for VMware exclusively in California. Because, as discussed above, the VMware Equity was intended as compensation for the personal services appellant Cremel provided to VMware between the various grant dates and exercise or vesting dates, and all of these services were performed in California, the income earned in 2011 and 2012 upon the exercise and vesting of the VMware Equity is California source income. (*Stabile*, *supra*.) Such compensation income earned for services performed exclusively in California remains California source income even though the income is community income and a nonresident, nonearning spouse is ultimately responsible for reporting and paying tax on one-half of such income. (*Li*, *supra*; *Appeal of Taylor* (88-SBE-028) 1988 WL 159784 (*Taylor*); *Appeal of Browne* (75-SBE-019) 1975 WL 3280 (*Browne*).) Accordingly, appellant Koeppel's community property share of the VMware Equity income constitutes California source income and is therefore taxable in this state for the 2011 and 2012 tax years.

Our Precedential Opinion in *Li*

We reached a similar conclusion with respect to wage income in *Li.* In *Li,* appellant was a resident and domiciliary of California while appellant's spouse was a domiciliary of Texas and nonresident of California. We noted that "the wage income earned by appellant in California is California source income." Because appellant was domiciled in California when this wage income was earned, pursuant to California's community property laws, we concluded that the income was community income and "one-half of appellant's wage income is considered California source income of appellant's spouse." (*Li, supra*.)

Appellants contend that this conclusion in *Li* is "flawed" because it cites *Malcom, Mitchell,* and *Browne* for the conclusion that "under California's community property laws, one-half of the resident spouse's salary and income is generally considered to be California source income of the nonresident spouse." Appellants contend that this conclusion "is not made by any of those cases," and that none of the cases cited in *Li* address the sourcing of such community income. While appellants are correct in noting that *Malcom* and *Mitchell* do not specifically

address sourcing of community income,[10] *Browne* did in fact consider and address the sourcing issue.

The State Board of Equalization's (Board) Decisions in *Browne* and *Taylor*[11]

In *Browne*, *supra,* 1975 WL 3280, appellant Ms. Browne lived and worked in California as a teacher. In January 1968, Ms. Browne's husband, Mr. Browne, accepted employment in El Salvador and left California. Mr. Browne returned to California in late August 1969. Ms. Browne filed separate California returns for 1968 and 1969, reporting and paying tax on all of her earnings but did not include any of her husband's out-of-state earnings. Mr. Browne did not file California returns for 1968 or 1969.

While the primary issue in *Browne* was whether Ms. Browne was responsible for California income taxes on her one-half community property interest in the income Mr. Browne earned while living and working in El Salvador,[12] the Board also considered the separate issue of whether Mr. Browne was similarly responsible for California income taxes on his one-half community property interest in the income Ms. Browne earned while living and working in California. This issue was addressed by the Board in the context of Ms. Browne's estoppel argument. In reaching a decision on the estoppel issue, the Board specifically concluded that "[a]ppellant's [Ms. Browne's] earnings appear to have been community income ..... As such, decedent's [Mr. Browne's] estate would have been liable for tax on one half thereof." In our review, because Mr. Browne was a nonresident at the time this income was earned, the Board must have made this conclusion on the basis that Ms. Browne's earnings were derived from performing personal services in California and thus half of that income constitutes California source income to Mr. Browne.

A similar result was reached by the Board in *Taylor*, *supra*, 1988 WL 159784. In *Taylor*, the Board concluded that during the time Ms. Taylor was a resident and Mr. Taylor was a

[10] *Malcom* and *Mitchell* are cited in *Li* for their holdings that the nonearning spouse must report and pay tax on his or her one-half community property interest in the community income.

[11] Office of Tax Appeals (OTA) is the successor agency to the Board, which previously decided franchise and income tax appeals prior to the creation of OTA.

[12] Ms. Browne's one-half community property interest in the income earned by Mr. Browne while living and working in El Salavador is includable in Ms. Browne's California taxable income as a result of Ms. Browne's status as a resident of California during the 1968 and 1969 tax years. As a California resident, Ms. Browne is taxed on her entire taxable income (regardless of source). (R&TC, §17041(a).)

nonresident of California, Ms. Taylor was "required to report her community property share of the total combined community, i.e. one-half of her own wages and one-half of her husband's earnings."[13] The Board further concluded, "In addition, Mr. Taylor would be required to file a nonresident return showing any California-source income including his one-half share of his wife's income."[14]

Therefore, the conclusion in *Li* that "under California's community property laws, one-half of the resident spouse's salary and income is generally considered to be California source income of the nonresident spouse," is entirely consistent with the Board's prior decisions in both *Browne* and *Taylor*. *Li* is also consistent with our above-described two-step analysis. First, because appellant (the resident, earning spouse) was domiciled in California, a community property state, appellant's spouse (the nonresident, nonearning spouse) had a marital property interest in one-half of appellant's income. Second, because the wage income was compensation for personal services appellant performed in California, one-half of appellant's wage income was found to be California source income to appellant's spouse.[15]

To the extent there is any ambiguity as to the proper analysis, we conclude that in situations such as this, where one spouse is a resident of California and the other spouse is a nonresident of California, the determination as to whether an item of income is taxable in California to the nonearning spouse can be broken down into the two-step analysis discussed above. As previously noted, the first step is to determine the nonearning spouse's marital property interest in the earning spouse's income. The resolution of this first question is generally governed by the laws of the state where the earning spouse is domiciled. (See *Li*, *supra*; *Schecter v. Superior Court*, *supra*, at p. 10; *Rozan v. Rozan*, *supra*, at p. 326.) Where the income

[13] While Mr. Taylor was found to be a nonresident of California for the tax years at issue, the Board concluded that Mr. Taylor remained a California domiciliary making California community property law applicable to the income he earned while a living and working in Malta.

[14] Notably, Mr. Taylor was not required to include his one-half share of his own earnings on his California nonresident return because this income, earned while he was living and working in Malta, is not California source income. However, Mr. Taylor's one-half share of his wife's income, earned while she was living and working in California, is California source income. Thus, the Board concluded that Mr. Taylor would be required to report this income on his nonresident return.

[15] With respect to appellants' contention that *Li* is inapplicable here since it addresses wage income rather than income from "property governed by IRC Section 83," we note that the VMware Equity income at issue here is properly treated as compensation for services. (*Stabile*, *supra.*) Because both appellant in *Li* and appellant Cremel in this appeal performed all of their employment-related services in California, we see no reason to treat the compensation income earned in connection with the VMware Equity any differently from the wage income in *Li*.

in question is community property, one-half of the income is attributable to each spouse and each spouse must report and pay tax on his or her respective one-half community property interest in the income. (See *Mitchell*, *supra*; *Malcom*, *supra*; *Poe v. Seaborn*, *supra*.)

If the nonearning spouse has an interest in the earning spouse's income, the second step is to determine whether the nonearning spouse's community property interest in the income is taxable in California either because the nonearning spouse is a resident of California who is taxed on all income, regardless of its source (R&TC, § 17041(a)), or because the nonearning spouse is a nonresident of California and the income is California source income. (R&TC, §§ 17041(b) & (i), 17951.) The source of the income in the hands of a nonearning, nonresident spouse is determined by applying California's nonresident sourcing rules to the facts surrounding how the income was generated as if the nonearning, nonresident spouse had derived the income directly from the source from which the earning spouse derived it.

Here, the VMware Equity income was paid as compensation to appellant Cremel for personal services he performed exclusively in California. Because, under step one, appellant Koeppel is attributed one-half of that community income, she is treated, under step two, as if she had derived that income herself directly from the source from which appellant Cremel derived it. Under California's nonresident sourcing rules, compensation for personal services performed in California is California source income. (Cal. Code Regs., tit. 18, § 17951-5.) Accordingly, since the VMware Equity income was earned by appellant Cremel for personal services performed solely in California, that income is entirely California source income in the hands of appellant Koeppel, the nonearning, nonresident spouse, and she must pay tax on it in this state.

Appellants' Argument Regarding Internal Revenue Service (IRS) Revenue Ruling 2002-22

As it relates to this second step, appellants contend that appellant Koeppel's community property interest in the VMware Equity income is not California source income because appellant Koeppel was a nonresident of California at the time this income was earned. Appellants specifically contend that "[appellant Koeppel] is treated as if she performed the services for VMware earning her 50 [percent] of the couple's community property earnings from the options," and that because she lived in France at the time this income was earned, "she is treated as if she worked in France for [VMware]." In support of their position that appellant Koeppel must be treated as if she performed the services for VMware, appellants rely

exclusively on certain language found in IRS Revenue Ruling 2002-22. (Rev. Rul. 2002-22, 2002-19 I.R.B. 849.)

Citing *Poe v. Seaborn*, *supra*, the IRS in Revenue Ruling 2002-22 first noted that where compensation rights are earned through the performance of services by one spouse in a community property state, the portion of the compensation treated as owned by the nonemployee spouse under state law is treated as the gross income of the nonemployee spouse for federal income tax purposes. The IRS then concluded where NQSOs have been transferred by an employee spouse to a nonemployee spouse incident to divorce pursuant to IRC section 1041, upon the subsequent exercise of NQSOs, the NQSOs transferred to the nonemployee spouse has the same character and is includible in the gross income of the nonemployee spouse under IRC section 83(a) "to the same extent as if the [nonemployee] spouse were the person who actually performed the services." Appellants rely on this quoted language to conclude that for purposes of determining the source of appellant Koeppel's community property share of the VMware Equity income, appellant Koeppel, the nonemployee spouse, is treated as the person who performed the services for VMware and that these services must therefore be treated as performed in France since appellant Koeppel was living in France at the time the VMware Equity income was earned.

However, appellants' reliance on this language in Revenue Ruling 2002-22 to reach this conclusion is misplaced. Revenue Ruling 2002-22 simply did not address the issue of sourcing of a nonemployee spouse's community property interest in the income earned upon the exercise of NQSOs. Instead, Revenue Ruling 2002-22 only addressed and considered which spouse must recognize and report the income earned upon the exercise of NQSOs: the employee (transferor) spouse or nonemployee (transferee) spouse.[16] While it may be appropriate to treat the nonemployee spouse "as if the [nonemployee] spouse were the person who actually performed the services" for the purpose of determining which spouse must recognize the income earned upon the exercise of the NQSOs, it does not necessarily follow that this treatment or analysis is appropriate for all purposes or in resolving other issues. The quoted language does not focus on the location where the nonemployee spouse is deemed to perform the services (just that the nonemployee spouse is deemed to perform them). This, along with the fact that California sourcing is specific to California, makes this ruling inapplicable here.

[16] This would be relevant to step one rather than step two of the two-step analysis described above.

The IRS's Subsequent Modifications in Revenue Ruling 2004-60

Additionally, the IRS subsequently modified and restated the concept and language relied upon by appellants in Revenue Ruling 2002-22 in Revenue Ruling 2004-60. (Rev. Rul. 2004-60, 2004-24 I.R.B. 1051.) In Revenue Ruling 2004-60, the IRS notes that, "Rev. Rul. 2002-22 holds that, upon the exercise of a [NQSO] obtained by a nonemployee spouse pursuant to divorce, the property transferred to the nonemployee spouse by the employer has the same character and is includible in the income of the nonemployee spouse under [IRC section] 83(a) *to the same extent as the property would have been includible in the income of the employee spouse had the option been retained and exercised by the employee spouse.*" (Rev. Rul. 2004-60, 2004-24 I.R.B. 1051, emphasis added.) Thus, Revenue Ruling 2004-60 concludes that the compensation realized on the exercise of the NQSOs by the nonemployee spouse "retain their character as wages of the employee spouse for purposes of [the Federal Insurance Contributions Act (FICA)]." As a result, the income from the exercise of the NQSOs "is subject to FICA to the same extent as if paid to the employee spouse," even though it is included in the nonemployee spouse's taxable income for federal tax purposes pursuant to Revenue Ruling 2002-22. This outcome would not be appropriate if the nonemployee spouse were treated "as if the [nonemployee] spouse were the person who actually performed the services" for the employer for all purposes.

Because Revenue Ruling 2002-22 does not specifically address the sourcing of income earned upon the exercise of NQSOs and the wording relied upon by appellants in Revenue Ruling 2002-22 was subsequently modified and restated by Revenue Ruling 2004-60, we find appellants' reliance on Revenue Ruling 2002-22 to conclude that appellant Koeppel must be treated as if she were the person who performed the services for VMware for the purpose of determining the source of the VMware Equity income to be misplaced. While it is undisputed that following her move to France in July 2008, appellant Koeppel performed all of her services for the marital community in France, it is equally true and undisputed that appellant Cremel performed all of his employment-related services for VMware, the employer that paid the compensation in question, in California. Because the VMware Equity income is compensation for appellant Cremel's services and these services were performed exclusively in California, the VMware Equity income earned upon the exercise and vesting of VMware Equity in 2011 and 2012 is California source income. The fact that this income is community income under California law and appellant Koeppel has "such an interest in the community income that she

should separately report and pay tax on one half of such income" (*Malcom*, *supra* at p. 794.) does not change the nature of this income as California source income.

Appellants' Arguments Regarding Community Property Law

Appellants contend that this outcome does not properly respect California community property law or appellant Koeppel's contributions to the marital community which gives rise to appellant Koeppel's community property interest in the income and property acquired by the community during their marriage. Appellants further contend that this conclusion can only be reached if appellant Koeppel performed her services in California or if such income is first treated as earned by appellant Cremel who then gave half of it to appellant Koeppel.[17]
We disagree. We conclude that the two-step analysis discussed above properly balances California community property law with California's income tax sourcing rules.

In step one, California community property law and appellant Koeppel's contributions to the marital community are properly respected by recognizing that the income in question is community income and that appellant Koeppel therefore has a vested interest in one-half of this community income such that she is responsible for reporting and paying income tax on such one-half interest. In step two, California's income tax sourcing rules are similarly respected by recognizing and treating compensation income earned for employment services performed exclusively in California as California source income regardless of whether that income is treated as community property vested equally in both spouses or the separate property of the employee spouse only. This analysis properly treats the income as being earned by the community while also recognizing that such community income was paid as compensation for employment-related services which were performed exclusively in California, and is thus, California source income.

Issue 2: Whether FTB's proposed assessment issued to appellant Koeppel for the 2012 tax year is barred by the statute of limitations.

In general, FTB must issue a proposed assessment within four years of the date the taxpayer files his or her California return. (R&TC, § 19057(a).) Here, appellant Koeppel's 2012

[17] Appellants cite to *Mitchell*, noting that the U.S. Supreme Court in *Mitchell* specifically found that, "The acquisition of all property during the marriage is due to the joint or common efforts, labor, industry, economy, and sacrifices of the husband and wife. . ." and "the wife's rights in and to the community property do not rest upon the mere gratuity of her husband ....." (*Mitchell*, *supra*, at p. 200.)

California 540NR was untimely filed on June 30, 2019. The NPA proposing additional tax was issued less than eight months later on February 20, 2020. Because the NPA was issued on February 20, 2020, which is less than four years from the date appellant Koeppel's 2012 California 540NR was filed, the NPA was issued timely.

Appellant Koeppel asserts that the assessment is barred by the statute of limitations because "the income the FTB is proposing to tax was fully reported to the State of California as non-[California] source income on a 2012 Form 540 filed by [appellant] Cremel in April of 2013." However, R&TC section 19057(a) provides that the term "return" means the return required to be filed by the taxpayer and does not include a return of any person from whom the taxpayer received an item of income, gain, loss, deduction, or credit. Because the NPA in question for the 2012 tax year was issued to appellant Koeppel, the applicable return for purposes of the statute of limitations under R&TC section 19057(a) is the Form 540NR filed by appellant Koeppel for the 2012 tax year on June 30, 2019, not the separate Form 540 appellant Cremel filed with his new spouse in April 2013.[18] Thus, appellant Cremel's filing of a Form 540 in April 2013, reporting and subtracting appellant Koeppel's $1,343,351 community property share of the VMware Equity income from his (and his new spouse's) 2012 California taxable income, simply is not relevant to the statute of limitations applicable to the NPA issued to appellant Koeppel, a separate taxpayer.

Appellant Koeppel's assertions that appellant Cremel's "Form 540 provided the FTB with all the relevant information to fully report such income earned by [appellant Koeppel]" is equally unavailing. Until appellant Koeppel filed a California return, there was no statute of limitations limiting FTB's ability to issue a proposed assessment to appellant Koeppel with respect to the 2012 tax year. (R&TC, §19057.) Appellant Koeppel did not file her 2012 Form 540NR until June 30, 2019. Thus, the NPA issued to appellant Koeppel on February 20, 2020, was timely and is not barred by the statute of limitations.

[18] Appellant Koeppel and appellant Cremel were divorced on May 14, 2012. For the 2012 tax year appellant Cremel timely filed a Form 540 with his new spouse using the married filing jointly filing status. Appellant Koeppel later filed a separate Form 540NR using the single filing status after FTB issued a demand for such tax return to appellant Koeppel.

Issue 3: Whether the late-filing penalty was properly imposed with respect to appellant Koeppel's 2012 tax year.

California imposes a penalty for failing to file a return on or before the due date, unless the taxpayer shows that the failure is due to reasonable case and not due to willful neglect. (R&TC, § 19131(a).) When FTB imposes a late-filing penalty, it is presumed to have been correctly imposed, and the burden of proof is on the taxpayer to show that reasonable cause exists to abate the penalty. (*Appeal of Xie*, 2018-OTA-076P.) To overcome the presumption of correctness, the taxpayer must provide credible and competent evidence supporting a claim of reasonable cause. (*Ibid*.) To establish reasonable cause, the taxpayer must show the failure to timely file a return occurred despite the exercise of "ordinary business care and prudence." (*Appeal of Friedman*, 2018-OTA-077P.)

Appellant Koeppel asserts that the late-filing penalty was not properly imposed or should be abated either because appellant Koeppel's 2012 California source income was less than California's filing threshold and she therefore did not have a California filing requirement for 2012 or because reasonable cause is established by the "applicable tax authority supporting [appellant Koeppel's] position." However, because we have concluded that appellant Koeppel's $1,343,351 community property share of the VMware Equity income earned in 2012 is California source income, appellant Koeppel was required to file a return in California for the 2012 tax year reporting this income. (R&TC, § 18501(a).) Because appellant Koeppel's Form 540NR for the 2012 tax year was not filed until June 30, 2019, more than six years late, the late-filing penalty was properly imposed.

With respect to appellant Koeppel's reasonable cause argument, we note that ignorance of the law is not reasonable cause for the failure to comply with statutory requirements. (*Appeal of Diebold, Inc*. (83-SBE-002) 1983 WL 15389.) Although appellant Koeppel may have had a sincere belief that she was not required to file a return in California for the 2012 tax year, that belief alone does not constitute reasonable cause for the failure to file a timely return. (*Appeal of Beam* (78-SBE-042) 1978 WL 3956.) Appellant Koeppel did not exercise ordinary care when she failed to acquaint herself with the requirements of California tax law. (*Appeal of Diebold, Inc., supra*.) Additionally, good faith reliance on professional advice may, in certain circumstances, provide a basis for a reasonable cause defense. (*Repetto v. Commissioner,* T.C. Memo. 2012- 168.) However, appellant Koeppel has not provided any evidence or argument to

establish that she relied on a tax professional in deciding not to file a timely return in California for 2012 or that such tax professional's advice was based on full disclosure of the relevant facts. (See *Estate of La Meres v. Commissioner* (1992) 98 T.C. 294, 315-318.) Thus, appellant Koeppel has not demonstrated that the late-filing penalty was improperly imposed or that it should be abated for reasonable cause.

HOLDINGS

1. Appellant Koeppel's community property interest in the income earned during the 2011 and 2012 tax years from NQSOs and RSUs granted to appellant Cremel is California source income.
2. FTB's proposed assessment issued to appellant Koeppel for the 2012 tax year is not barred by the statute of limitations.
3. The late-filing penalty was properly imposed with respect to appellant Koeppel's 2012 tax year.

DISPOSITION

FTB's deemed denial of appellants' claim for refund for the 2011 tax year and action proposing to assess additional tax and imposing a late-filing penalty for appellant Koeppel's 2012 tax year are sustained.

DocuSigned by:
Cheryl Akin
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Cheryl L. Akin
Administrative Law Judge

We concur:

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

DocuSigned by:
Huy "Mike" Le
A1178...
Huy "Mike" Le
Administrative Law Judge

Date Issued: 5/18/2021