OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19024304
N. PRINCE	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Eric Anderson, Anderson Tax Michael Vigil, Anderson Tax
For Respondent:	Mira Coutinho, Tax Counsel[1] Maria Brosterhous, Tax Counsel IV
For Office of Tax Appeals:	Tom Hudson, Tax Counsel III

J. JOHNSON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, appellant N. Prince appeals the action by respondent Franchise Tax Board of partially denying appellant's claim for refund for the 2012 tax year.[2]

Office of Tax Appeals Administrative Law Judges John O. Johnson, Sheriene Anne Ridenour, and Cheryl L. Akin held an oral hearing for this matter on September 29, 2020.[3] At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

ISSUE

Whether appellant has shown error in respondent's determination concerning the allocation of income from appellant's restricted stock units (RSUs) that vested in the 2012 tax year.

[1] Respondent's representative is referred to as Mira Patel in the hearing and associated transcript.

[2] The portion of the refund that was denied and is at issue in this appeal is $62,937.

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

FACTUAL FINDINGS

1. Appellant began working for Facebook, Inc. in Palo Alto, California in 2007.
2. Appellant accepted an offer for a temporary overseas position with Facebook Singapore in June 2010. Appellant accepted a permanent position with Facebook Singapore in July 2012.
3. Later in 2012, appellant accepted a position as a Media Solutions Manager for Facebook Australia, and thereafter relocated to Australia.
4. Appellant has not been a California resident since he departed for Singapore in 2010. Appellant visited California for work-related purposes for three days in 2011 and for six days in 2012.
5. Appellant's compensation from Facebook, Inc. included six grants of RSUs that all required appellant to continue working for Facebook in order to receive the stock. These RSUs were granted on six dates ranging from 2007 to 2010 and they all vested in the 2012 tax year while appellant was a California nonresident, as shown below:

Shares	Grant Date	Vesting Date
70,000	12/18/2007	10/25/2012
21,420	8/26/2009	10/25/2012
550	8/26/2009	11/01/2012
545	8/26/2009	12/01/2012
3,130	8/26/2010	10/25/2012
390	8/26/2010	11/15/2012

6. In August 2013, appellant filed a 2012 California nonresident income tax return, reporting the value of the six grants of RSUs at their various 2012 vesting dates, which totaled $2,230,095. The return reported California source income of $1,832,724, total tax of $215,369 and tax due of $38,173. Self-assessed penalties and interest of $2,695 were included, and the reported amount due was remitted with the return.
7. In December 2016, appellant filed an amended 2012 California nonresident income tax return. The amended return reported California source income of $827,446, which was a decrease of $1,005,278 from the amount shown on the original return. Appellant explained that he amended his return to allocate to California the income from the RSUs based on the per-share price on the date he left California, in 2010, when the fair market value per share was $7.27 for the Facebook stock. This allocation resulted in a revised

total tax of $97,236, and, after self-assessed penalties and interest, appellant claimed a refund of $128,575.[4]

8. Following an audit of appellant's 2012 taxable year, respondent determined that appellant had overreported his income on his original return but underreported his income on his amended return. Respondent determined that appellant's total taxable California source income was $1,012,081 in 2012 by multiplying appellant's total income from each of the RSUs by the ratio of appellant's California workdays from the grant date to the vesting date over the total number of workdays during that period (as shown in the chart below):

Grant Date	Vesting Date	CA Workdays	Total Workdays	CA %	Total Taxable Income	Total Taxable CA Source Income
12/18/2007	10/25/2012	648	1,219	53.16%	$1,624,700	$863,691
8/26/2009	10/25/2012	223	794	28.09%	$497,158	$139,652
8/26/2009	11/01/2012	223	799	27.91%	$11,613	$3,241
8/26/2009	12/01/2012	223	820	27.20%	$15,260	$4,151
8/26/2010	10/25/2012	9	543	1.66%	$72,647	$1,206
8/26/2010	11/15/2012	9	558	1.61%	$8,717	$140

9. On October 23, 2018, respondent issued a Notice of Action that revised appellant's California source income to $1,012,081 and allowed for an overpayment of $68,691.63, plus applicable interest, and issued a refund to appellant of $81,822.74. Appellant then filed this timely appeal of respondent's partial denial of the refund claim.

DISCUSSION

California taxes the income of nonresidents that is derived from California sources. (R&TC, § 17041(i)(1)(B).) R&TC section 17951 provides that the gross income of nonresidents includes only the gross income from California sources, including compensation for personal services performed in California. (See Cal. Code Regs., tit. 18, §§ 17951-2, 17951-5.)

[4] Appellant included with his claim for refund a revised 2012 California nonresident income tax return (540NR) reporting a refund amount of $87,707, based on the difference between California tax withheld and his revised reported tax liability, plus adjustments for penalties and interest. However, appellant also included an amended 2012 California return (540X), which included the additional tax paid with his original return of $38,173, leading to the larger refund amount of $128,575, after adjustments for penalties and interest.

Internal Revenue Code (IRC) section 83, which is incorporated into California law by R&TC section 17081, governs the taxation of stocks and other property (including the RSUs at issue here) transferred in connection with the performance of services. Gross income for tax purposes includes the gains from restricted stock options 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 RSUs remained subject to a substantial risk of forfeiture until the stated vesting dates in 2012 because the vesting of the units was specifically conditioned on appellant's continued employment with the company through each vesting date. (See *Appeal of Stabile*, 2020-OTA-198P (*Stabile*).) It is undisputed that appellant received the RSUs from Facebook, Inc. as compensation for services, and that appellant's gains from the RSUs became subject to tax in 2012, pursuant to IRC section 83.

California Code of Regulations, title 18, section 17951-5(b) states that compensation for personal services, such as that paid to appellant in the form of RSUs, "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." For purposes of sourcing the income at issue, no specific method of allocation is specified by this regulation or by any other applicable provision of California law. Respondent has provided a formula for the allocation of appellant's income, and appellant has provided an alternative allocation formula, contending that respondent's formula is "inherently arbitrary and yields an unreasonable result."[5]

[5] Respondent contends that, when it has applied a formula for the allocation of income, appellant then bears the burden of showing that the application is intrinsically arbitrary or that it produces an unreasonable result, citing *Appeal of Gustafson* (88-SBE-027) 1988 WL 159783 (*Gustafson*). Appellant contends *Gustafson* is distinguishable because it dealt with a credit, which is an exemption from tax strictly construed against the taxpayer, whereas, here, the imposition of tax on income is not so strictly construed. Furthermore, appellant argues, *Gustafson* relies upon *Union Carbide*, which dealt with a constitutional argument. (*Appeal of Union Carbide* (57-SBE-018) 1957 WL 1178.) Appellant also argues that this appeal is further distinguishable from those decisions, as well as from *Stabile*, in that appellant has provided a reasonable allocation methodology in the alternative, and perhaps it is respondent that now bears the burden of showing appellant's formula to be unreasonable. However, as concluded below,

Respondent asserts that the working days method used by its auditor is reasonable, based on the facts and circumstances of this case (i.e., respondent multiplied appellant's total income from each of the RSUs by the ratio of appellant's California workdays from the grant date to the vesting date over the total number of workdays during that period). Appellant disagrees, asserting that respondent's working days allocation method is not reasonable in this instance because appellant's restricted stock "sky-rocketed" in value after appellant left California, and appellant's personal services directly contributed to the stock's appreciation.
Appellant explains that the value of Facebook stock increased from $7.27 per share when he left California to $28.00 per share during the 2012 tax year when vesting occurred. Appellant proposes to use his annual stock appreciation method[6] to determine the portion of the gain to be allocated to California. Under this method, the income attributable to appellant's compensation for personal services in California would equal the value of the stock on appellant's last day of work in California ($7.27 per share) minus the price of the stock on the date of the grant.

Generally, the enticement of stock options is predicated on the anticipation that the stock will continue to gain in value over time from grant date to vesting date, hopefully at an accelerating rate. Following appellant's proposed allocation of capping California source income at the value of the stock upon departure allocates an inflated proportion of the compensation to the later years for those situations in which the value increases at the hoped for accelerating rate, like it did in the facts before us. Since this uneven allocation will occur irrespective of the nature of the services performed, appellant's allocation formula can create a misrepresentation of the relationship between the services performed in each location and the state to which stock compensation is allocated. This is contrary to the applicable rules set forth in the statutes and regulations discussed above. While it is unquestioned that the value of the RSUs increased sharply after appellant left California, the variability in value of the RSUs over time does not automatically make them less attributable to the work previously performed in

appellant has not provided a reasonable allocation method, and we therefore need not determine whether, if it had done so, the burden would shift to respondent to prove it was unreasonable.

[6] Appellant asserts that his stock appreciation method is still a working days method, but one that focuses on the current value of the stock as of the date he left California.

California.[7] (Cf. *Willacy v. Cleveland Board of Income Tax Review* (2020) 159 Ohio St.3d 383, 392.) If evidence existed that showed appellant's personal services had a significant impact on the increase in the stock value, then it would be possible to link the stock appreciation to appellant's services performed after he became a nonresident of California, but appellant has failed to prove such evidence.

To be sure, appellant's services were valuable to the company, as noted in the record by opportunities overseas, promotions, and increases to annual salary during the time period at issue. However, these forms of compensation appear to constitute the limits of any increase in his compensation commensurate to the performance of his services, not the appreciation in value of the RSUs.[8] Appellant's compensation pursuant to the RSUs was based on his continued employment through the vesting date, and was not specifically impacted (either through further restrictions on vesting or an adjustment after the date of granting in the amount of RSUs to vest) by the overall performance of the company or the nature of his services rendered for the company. These facts do not support the contention that the growth in the value of the stock after appellant left California was in any way specifically tied to the services appellant performed outside of California.[9]

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[7] Treasury Regulation section 1.83-7(b)(3), pertaining to the taxation of nonqualified stock options, provides relevant guidance in clarifying that "the fair market value of an option is not merely the difference that may exist at a particular time between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period." Likewise, here, the RSUs only acquired certain value as of the date they vested and were no longer contingent interests. To allocate income based on a comparable stock price on a specific date during the vesting period, without evidentiary support beyond the fact that the stock rose sharply after that date, is inherently arbitrary in that it disregards the potential future value of the stock for one period and not for another.

[8] At the hearing, appellant referenced the increase in responsibility appellant had between when he left California and a couple years later when he was a manager, indicating that "we should take that into account in the stock value." In response to a request for elaboration, appellant clarified that the increase of relative value in the stock during the vesting periods and the increase in appellant's responsibilities within the organization could be coincidence, but that it was reasonable to think that his compensation for the RSUs should not be ratable the same way that his salary was not ratable over that period of time. However, appellant's contention on this point is mere speculation. Rather, as discussed herein, to reach such a conclusion, there needs to be an indication that any increase in the value of the RSUs was related to appellant's subsequent promotions or specific services provided at any given time during the vested period.

[9] For comparison, in *Appeal of McKee* (68-SBE-023) 1968 WL 1652, addressed by both parties at the hearing, the Board of Equalization (Board) determined that bonus payments received while the taxpayer was in California was not sourced to California, but rather to Oregon, where the company making the payments was located and operated. In that appeal, the Board made specific findings to reach this conclusion, noting that the taxpayer was the principal officer for the company, that the taxpayer was not working for the company while in California, and that the profits earned that resulted in the bonus payments were generated during the busy season and the time

Furthermore, there is no indication that there exists any link between the performance of services (i.e., services appellant performed in California versus services appellant performed outside California) and the accelerated increase in the value of the stock post 2010.[10] The primary reason appellant benefited from the increase in the value of the stock was his continued employment with the company throughout the vesting period, not any change in the services appellant performed for the company after leaving California. Therefore, it appears that the services performed throughout the entire duration of his employment from the grant dates through the vesting dates equally contributed to the growth in value of appellant's restricted stock unit's appreciation. As such, appellant's allocation formula appears intrinsically arbitrary, and produces an unreasonable result when viewed under the goal of allocating to California that portion of the total compensation which is reasonably attributable to personal services performed in this state.

Respondent has based its proposed allocation on a working days formula that treats evenly the growth in value recognized upon the vesting date across the entire duration of the services provided. While the working days formula is in no way a mandatory formula to apply in every instance, this method has been recognized as an acceptable formula depending on the facts of the case. (See, e.g., *Stabile*, *supra*.) As discussed above, the available evidence provided on appeal leads to the conclusion that the income recognized from the RSUs is equally attributable to appellant's services provided to the company throughout the entire vesting period, and not disproportionately attributable to services provided within or without California. Accordingly, we find that the facts support the application of the working days allocation formula as provided by respondent, and determine that respondent's method of allocation is reasonable and is consistent with California law.

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during which the taxpayer was physically in Oregon rather than California. These facts gave rise to the finding that the bonus payments were directly tied to the services the taxpayer performed while operating the business in Oregon, and conversely the payments were not tied to the portion of the year during which the taxpayer was in California and not performing services. Ignoring for the sake of discussion the legal distinctions between bonus payments and the RSUs at issue here, we conversely have no such facts in this appeal showing appellant's personal services during specific periods should be allocated a larger portion of the income generated from the vesting of the RSUs.

[10] Based on the evidence provided, it is not evident that the nature of appellant's position and duties necessarily had a significant impact on the value of Facebook stock during the period at issue.

HOLDING

Respondent's working days allocation formula is reasonable and consistent with California law under the facts of this appeal.

DISPOSITION

The action of respondent in denying appellant's claim for refund is sustained.

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John O Johnson
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John O. Johnson
Administrative Law Judge

We concur:

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Sheriene Anne Ridenour
Administrative Law Judge

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Date Issued: 1/5/2021