

Irreconcilable Cases: California Taxation of Non-Resident Option Income

Case A

Mike Move-out lived in San Francisco and took a job in the Silicon Valley for Techno company in 1994. At the time he was hired, he was granted a nonqualified stock option to buy 10,000 shares of Techno company stock, a private company. Mike's option vested in 1999. Mike quit Techno in December 1999 and moved to Reno, Nevada to be closer to his parents. In February 2000, Techno went public and its stock hit \$200/share. Mike exercised his option (and immediately sold his stock) earning him \$2 million from his Techno option. Mike paid his federal tax liability in full on the \$2 million of option income but did not pay any state income tax since he was a resident of Nevada at the time he exercised his option and Nevada does not have a state income tax.

Case B

Mary Move-in lived in Reno and took a job in Reno for Techno NV company in 1994. At the time she was hired, she was granted a nonqualified stock option to buy 10,000 shares of Techno NV company stock, a private company. Mary's option vested in 1999. Mary quit Techno NV in December 1999 and moved to San Francisco to be closer to her parents. In February 2000, Techno NV went public and its stock hit \$200/share. Mary exercised her option (and immediately sold her stock) earning her \$2 million from her Techno NV option. Mary paid her federal tax liability in full on the \$2 million of option income but did not pay any state income tax since she believed the option income accrued while she was a resident of Nevada and was not taxable in California.

Question – Did Mike or Mary owe California income tax on the option income?

Inconsistent Positions

The option income earned by both Mike and Mary is essentially the same. The only difference is where they lived at the time the option was granted/vested (during employment) and where they lived when the option was exercised.

Taxpayer	Residence at grant/vesting	Residence at exercise
Mike	California	Nevada
Mary	Nevada	California

Whether Mike or Mary's option income is taxable in California would seem to depend on whether the option income (a) accrues during the time it was granted and vested (while employed) and is taxable by the state of employment or (b) whether it accrues at the time it is exercised and is taxable in the state where the taxpayer lived on the date of exercise. Mike took the position it is the latter and Mary claimed the former. In other words, they took inconsistent positions. Clearly, one of them must be right and one wrong. Who was right?

California Revenue and Taxation Code (RTC) section 17554 basically reaffirmed what the issue is in Mike and Mary's situation (repealed effective October 1, 2001). This statute said that residency at the time income is "earned" is critical not when income is received. If income from an option is earned during employment, then residency during employment governs the taxability of the option income. If option income is earned upon exercise, then where the taxpayer lives on the date of exercise controls.

The California State Board of Equalization (SBE) first answered the question regarding when option income accrues in *Appeal of Perelle* (December 17, 1958). In *Perelle*, the SBE held that option income accrues during employment (*i.e.*, when the option is granted/vests) not at exercise. In *Perelle*, the taxpayer was granted an option while employed in California and later exercised the option while a resident of Michigan. The SBE said the option income realized upon exercise was earned in California and therefore taxable by California.

According to the SBE in *Perelle*, Mike should have reported his option income in California and Mary's option income accrued while she was a resident of Nevada. It would therefore seem that Mary correctly reported her option income and Mike did not.

The SBE in *Appeal of Barnett* (October 28, 1980), however, held otherwise. In *Barnett*, the taxpayer was granted an option while working and living in Canada. He later retired, moved to California and exercised his option. The taxpayer did not report the option income in California presumably relying on *Perelle*. Upon auditing the taxpayer, the FTB determined that the option income accrued after the taxpayer moved to California.

The SBE in *Barnett* begins its analysis stating:

"The taxability of income when residence is changed is determined by when the income accrues....[I]f income realized from the stock option accrued while [taxpayers] were residents of Canada, it would not be taxable in California because nonresidents are taxed only on income from source within California. If the income accrued after appellants became California residents, it would be taxable in California ..."

This statement appears to be in line with RTC section 17554 – residency at the time the option income accrues governs. If the option income accrued at the time the taxpayer lived in Canada the option income is not taxable in California. In Mary's case, if the option income accrued while she was a resident of Nevada, the income upon exercise is not taxable in California. As discussed, according to *Perelle*, option income accrues during employment rather than when it is exercised.

At the SBE hearing in *Barnett*, the FTB took a position contrary to *Perelle*. The FTB argued that the option income did not accrue until the option was exercised since until the stock was exercised substantial contingencies existed as to both the right to receive income from the option and the amount of such income. The SBE agreed with the FTB's arguments noting, with regard to the first point, that if the taxpayer died prior to exercise, his estate had a limited time to exercise the option. Regarding the second point, the SBE

noted that it is not known how much income will be realized from the option until it is actually exercised since the stock acquired from the option varies in price and the option can be partially exercised.

The *Barnett* conclusion appears to be in direct conflict with *Perelle*. While there is no discussion in *Perelle* regarding forfeitability of the taxpayer's option, the price of the option was not determined until it was exercised. The amount of income that would eventually be generated by the option in *Perelle* was no more determinable than it was in *Barnett*. The SBE in *Barnett* stated the *Perelle* case "is distinguishable...since the income there was from a California source and therefore taxable in California whether or not the taxpayer was a resident". In other words, California source income is always taxable in California regardless of where the recipient lives. Without going into the accuracy of this statement (and whether it was accurate at the time *Perelle* was decided), the *Perelle* case was not decided under this principle. *Perelle* held that option income accrues at the time of employment not when exercised. *Barnett* held the opposite.

According to the State of California, both Mike and Mary reported their income incorrectly. *See also*, FTB Publication 1004 (stating that taxpayers in either Mike or Mary's situation must pay California income tax on their option income). *Perelle*, *Barnett*, a few other SBE opinions, and FTB Publication 1004 are the only guidance Mike and Mary (and similarly situation taxpayers) have on this issue. SBE opinions and FTB Publications are not binding on California courts. A California court should address the inconsistency between *Perelle* and *Barnett*. Many taxpayers are currently in the audit stage with the FTB over this issue. Hopefully, a taxpayer will litigate this issue and a California appellate court will publish an opinion clarifying whether Mike or Mary is correct.

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