

CALIFORNIA STATE BOARD OF EQUALIZATION
SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Appeal of:)	Case No. 610025
)	Oral hearing date: August 5, 2014
RICHARD N. EISENBERG AND)	Decision rendered (finality date):
)	December 19, 2014
ANITA EISENBERG)	Publication due by: April 17, 2015

Representing the Parties:

For Appellants:	Steven R. Mather, Esq. Kajan Mather and Barish
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For Franchise Tax Board:	Maria Brosterhous, Tax Counsel
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Counsel for the Board of Equalization:	John O. Johnson, Tax Counsel III
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LEGAL ISSUES

Whether appellants have demonstrated error in respondent's proposed assessment, which was based on respondent's determination that approximately 88 percent of a payment received by appellant-wife was taxable as wage income received for services provided in California, and whether the accuracy-related penalty should be abated.

BACKGROUND

Appellant-wife sold Castalian Music, LLC (Castalian) to Virgin Records America, Inc. (Virgin Records) through a Purchase Agreement dated September 7, 1999. The Purchase Agreement transferred all of appellant-wife's membership interests in Castalian for a total purchase price of \$3,550,000. In conjunction with this sale, appellant-wife also entered into an employment contract (Employment Agreement) to serve as the president of Castalian for a period of seven years.

Appellant-wife's Employment Agreement provided for an annual salary, yearly bonuses, and an "Incentive Bonus" to be paid in two installments called the "First Tranche" and the "Second

Tranche.” Only the Second Tranche of the Incentive Bonus is at issue in this appeal. This payment was calculated with reference to pretax net earnings during the final three years of the employment term and would be adjusted or cancelled if there was an early termination of appellant-wife’s employment.

In February of 2006, appellants married, and they relocated from California to Texas as of July 31, 2006. In January of 2007, appellant-wife received the Second Tranche payment, in the amount of \$6,285,250. Appellants filed a joint California income tax return as nonresidents and a federal tax return for 2007. In both tax returns, appellants reported wages of \$6,475,122, including the \$6,285,250 Second Tranche payment. However, on Schedule CA of their California tax return, appellants reported that the Castalian wages did not arise from a California source.

During audit, respondent determined that 88.2597 percent of the Second Tranche payment was compensation for the performance of services in California, applying the days appellant-wife worked in California during the three-year period compared to the total days she worked during this period. Respondent issued a Notice of Proposed Assessment (NPA) on December 28, 2010, based on a finding that \$5,547,343 (i.e., 88.2597 percent) of the \$6,285,250 Second Tranche payment was California source income, and proposed additional tax of \$562,524, plus applicable interest. The NPA also proposed an accuracy-related penalty of \$112,504.80. Following protest proceedings, respondent affirmed the NPA in a Notice of Action dated April 26, 2012.

This timely appeal followed. On appeal, appellants primarily argued that the Second Tranche payment did not constitute California source income on the ground that it was received in return for appellant-wife’s interest in Castalian, rather than as a payment for appellant-wife’s services.

APPLICABLE LAW

Under Revenue and Taxation Code (R&TC) sections 17041 and 17951, nonresidents are subject to California income tax on income from California sources. Pursuant to Regulation 17951-2, compensation for personal services is sourced to the place where the services are performed. Compensation for services must be allocated based on a reasonable apportionment method. (Cal. Code Reg., tit. 18, §§ 17951-2 & 17951-5.)

R&TC section 19164 provides for an accuracy-related penalty which is generally determined

in accordance with Internal Revenue Code section 6662. The penalty applies to the portion of the underpayment attributable to negligence or disregard of rules and regulations or to any substantial understatement of income tax. (Int.Rev. Code, § 6662(b).) There is a “substantial understatement of income tax” when the amount of the understatement for a taxable year exceeds the greater of ten percent of the tax required to be shown on the return, or \$5,000. (Int.Rev. Code, § 6662(d)(1).) The penalty may be abated if the taxpayer shows substantial authority for the taxpayer’s position, adequate disclosure and a reasonable basis, or reasonable cause and good faith. (Rev. & Tax. Code, § 19164, subd. (d); Int.Rev. Code, § 6664(c)(1); Cal. Code Regs., tit. 18, § 19164, subd. (a).)

FINDINGS OF FACT, ANALYSIS, & DISPOSITION

A preponderance of the evidence supports respondent’s determination that the payment at issue was made in return for services provided by appellant-wife. The payment was made in accordance with appellant-wife’s Employment Agreement, which described the payment as an “Incentive Bonus.” The payment was tied to appellant-wife’s provision of services to Castalian pursuant to the Employment Agreement and calculated by reference to the company’s financial success during the term of her employment. In addition, Castalian, which was now owned by Virgin Records, reported the payment as compensation on the Form W-2 it issued to appellant-wife, and appellants reported the payment as wages on their federal return. Appellants also reported the income as wages on their California tax return, although they deducted it on Schedule CA as wages not sourced to California.

On appeal, appellants provided statements and evidence from prior negotiations to support their position that the actual purchase price for Castalian was greater than the purchase price stated in the Purchase Agreement and included the payment at issue. For example, appellants provided a declaration from a Virgin Records executive in which he states in part his recollection that the purchase price was based on a multiple of pretax net earnings. However, the declaration is dated more than 15 years after the Purchase Agreement, and the executive acknowledges that he was not involved in the documentation of the purchase. Appellants also provided a November 18, 1998 letter from the purchaser’s attorney stating principal terms and conditions, however the letter states that the offer was subject to further negotiation and the execution of formal agreements.

The record indicates that various general financial terms were considered during arm’s-length

negotiations between the parties. When the parties settled on the final terms and conditions of the transactions, they recorded those terms and conditions in final executed agreements. Those final executed agreements, and the subsequent actions of the parties in conformity with the final agreements, demonstrate that the payment at issue compensated appellant-wife for services in accordance with the terms of the Employment Agreement, rather than as part of the purchase price for appellant-wife's interest in Castalian pursuant to the Purchase Agreement. We further note that there is no evidence that respondent was unreasonable in its calculation of taxable income based on the percentage of work days that appellant-wife performed services in California.

As noted above, the accuracy-related penalty may be abated if the taxpayer demonstrates reasonable cause and good faith. Here, appellants received the payment at issue after moving to Texas and disclosed the income on both their federal tax return and on the California tax return that they filed as nonresidents. Although appellants' Schedule CA incorrectly subtracted the income as non-California source income, appellant-wife's explanations at the hearing and the surrounding facts and circumstances persuade us that she had reasonable cause for the underpayment and endeavored in good faith to report her income properly based on the tax reporting recommended by qualified professionals.

ORDER

Pursuant to the analysis of the law and facts above, this Board ordered that the accuracy-related penalty for 2007 be abated, and that the action of the FTB on appellants' protest against the proposed assessment for 2007 otherwise be sustained. Adopted at Sacramento, California, this 18th day of December, 2014.

Jerome E. Horton _____, Chairman

Betty T. Yee _____, Member

George Runner _____, Member

John Chiang _____, Member