



State of California
Franchise Tax Board

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05.13.14

CHIEF COUNSEL RULING 2014-01

Re: Request for Chief Counsel Ruling

Dear *****,

You requested a Chief Counsel Ruling regarding how to properly source income received from a Restricted Stock Unit plan when a taxpayer lived in California on the date of grant, but became a nonresident of California prior to the vesting date. You also requested clarification regarding how to properly source income received from a Restricted Stock Unit plan when a California nonresident performed services in California prior to the vesting date.

FACTS

Taxpayer has been an employee of ***** since *****. Taxpayer received a grant of 32,000 restricted stock units (RSUs) with an RSU start date of ***** and a grant date of *****. The RSU plan provided for a two-part vesting requirement. First, the plan required the occurrence of an "Initial Vest Event," which was defined as the earlier of:

1. Six months after the effective date of an initial public offering (IPO); or
2. A change of control.

Additionally, the RSUs vested proportionately over a period of 48 months of continuous service with the company. A portion of the RSUs vested on the Initial Vest Event, the amount of which was based upon the Taxpayer's Continuous Service Status for one year. The remaining RSUs vested on a monthly basis thereafter.

Pursuant to a ***** agreement, Taxpayer received a second grant of 87,590 RSUs with an RSU start date of ***** , and a grant date of *****. Under this agreement,

the period of the vesting of the RSUs began *****, but the RSUs were not officially granted until *****.

These RSUs were subject to an Initial Vest Event of the earliest of:

1. *****;
2. An earlier date between ***** and *****, as specified by the company; or
3. The date of a Change of Control.

A portion of the RSUs vested on the Initial Vest Event, the amount of which was based upon the Taxpayer's Continuous Service Status for one year. Thereafter the remaining RSUs vested or vest on a quarterly basis.

The Taxpayer terminated his California residency on *****. He continued his employment with ***** and periodically travelled to California for business purposes.

The ***** IPO occurred on ***** and, pursuant to the vesting provisions of the RSU plan, the Initial Vest Event for the ***** RSUs occurred six months later on *****. As it was entitled to do for the second group of RSUs, granted in *****, ***** chose an earlier Initial Vest Event date of *****.

ISSUES

1. What is the proper method of determining the portion of California source income received by a taxpayer who was granted RSUs as a California resident, but did not recognize income on them until he became a nonresident?
2. What is the proper method of determining the portion of California source income received by a taxpayer who was granted RSUs as a California nonresident, but performed services for the employer in California before the RSUs vested?

HOLDING

The Taxpayer must use a reasonable apportionment method to determine the portion of California source income received. The most reasonable apportionment method to determine the portion of California source income received is to multiply the compensation received by a ratio of California working days from the grant date to the vest date over the total working days anywhere during the same period.

DISCUSSION

California residents are taxed upon their entire net income regardless of source, while nonresidents are taxed only on income from a California source.¹ Thus, part-year residents are taxed on their entire taxable income during the period they were residents and on the income derived from California sources during the period they were nonresidents.²

The taxation of restricted stock such as that here is governed by Internal Revenue Code (IRC) section 83(a), to which California tax law conforms under California Revenue and Taxation Code section 17081.³ IRC section 83(a) provides that a taxpayer does not recognize gross income when restricted stock is granted. Instead, a taxpayer recognizes taxable compensation to the extent the fair market value of the stock exceeds the option price when the restricted stock is vested or, in the words of the statute, at "the first time 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. . . ."⁴ It is well-established that gain from the vesting of the restricted stock is characterized as compensation for personal services.⁵

An RSU plan awards a taxpayer the right to receive a fixed payment equal to the value of a specified number of shares of employer stock.⁶ Unlike restricted stock options, an RSU plan allows a taxpayer to receive an amount based on the full value of a share, rather than only an amount equal to the increase in value from the date of grant through the vest date.⁷ The IRS treats RSUs like other forms of nonqualified stock options subject to a substantial risk of forfeiture, most specifically like restricted stock.⁸ The ***** RSUs are comparable to grants of restricted stock in a number of ways that are significant to this analysis. Like restricted stock, these RSUs have a clear grant date and a period of vesting. Also similar to restricted stock, their value is not recognizable on the grant date, but rather on the date the RSUs are vested.

Here, the RSUs were subject to a two-part vesting period. First, the vesting of the RSUs granted in **** was contingent upon the occurrence of the ***** IPO, but not effective until six months later on *****. Since the Taxpayer met the one year of Continuous Service Status requirement as of ***** , a portion of the RSUs vested as provided by the RSU agreement:

¹ Rev. & Tax. Code §§ 17041, 17951.

² Rev. & Tax. Code § 17041(b), (i).

³ Incorporated by reference in Revenue and Taxation Code section 17081.

⁴ Treas. Reg. § 1.83-7(a).

⁵ *Commissioner v. LoBue* (1956) 351 U.S. 243; *Appeal of Charles W. and Mary D. Perelle*, 58-SBE-057, Dec. 17, 1958.

⁶ BNA 385 T.M. II. E.

⁷ *Ibid.*

⁸ See Treas. Reg. § 1.409A-1(d)(1) ("Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial."); IRS Notice 2009-8 (1/26/2009); IRS Notice 2009-85 (11/9/2009).

[T]he number of RSUs that shall vest on the Initial Vesting Event shall be equal to the product obtained by multiplying the "Total Number of RSUs" identified . . . by a fraction, the numerator of which is the number of monthly anniversaries of the RSU Start Date on which the Participant was in Continuous Service Status from the RSU Start Date and the denominator of which is forty-eight (48). . . .

The remaining RSUs vested at a rate of 1/48 on a monthly basis on the 15th of each month. The entire amount of 32,000 RSUs met the second vesting requirement when the Taxpayer remained in the continuous service of ***** for 48 months from ***** to *****.

The **** grant was also subject to a two-part vesting. The first requirement of an Initial Vesting Event occurred on *****. Since the Taxpayer met the one year of Continuous Service Status requirement as of ***** , a portion of the RSUs vested as provided by the RSU agreement:

[T]he number of RSUs that shall vest on the Initial Vesting Event shall be equal to the product obtained by multiplying the "Total Number of RSUs" identified . . . by the sum of (x) twelve sixtieths (12/60) plus (y) a fraction, the numerator of which is the number of Quarterly Vesting Dates on which the Participant was in Continuous Service Status after the Cliff Date [i.e., the one-year anniversary of the RSU Start Date] and the denominator of which is twenty (20). . . .

The agreement provides that the Quarterly Vesting Dates will occur on ***** **, ***** **, ***** **, and ***** **. The remaining RSUs vested at a rate of 1/20 every quarter. The entire grant of 87,590 RSUs will meet the second vesting requirement if the Taxpayer remains in the continuous service of ***** for 60 months from ***** to *****.

When a taxpayer performs services in California during the period from the date of the grant of the restricted stock to the date of the vesting of the restricted stock and during this period becomes a nonresident, a portion of the compensation from the vesting of the restricted stock is California source income.⁹ Revenue and Taxation Code section 17041 provides that the California taxable income of a California nonresident includes gross income and deductions derived from sources within California, as determined in accordance with Revenue and Taxation Code section 17951 and the applicable regulations. Regulation section 17951-5, subsection (b), provides:

If nonresident employees are employed in this State at intervals throughout the year, as would be the case if employed in operating trains, boats, planes, motor buses, trucks, etc., between this State and other states and foreign

⁹ *Appeal of Robert C. and Marian Thomas*, 55-SBE-006, Apr. 20, 1955; *Appeal of Janice Rule*, 76-SBE-099, Oct. 6, 1976; *Appeal of Karl Bernhardt*, 84-SBE-153, Nov. 14, 1984.

countries, and are paid on a daily, weekly or monthly basis, the gross income from sources within this State includes that portion of the total compensation for personal services which the total number of working days employed within the State bears to the total number of working days both within and without the State. If the employees are paid on a mileage basis, the gross income from sources within this State includes that portion of the total compensation for personal services which the number of miles traversed in California bears to the total number of miles traversed within and without the State. *If the employees are paid on some other basis, the total compensation for personal services 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.* Gross income from sources within this State does not include qualified retirement income, as defined in Section 17952.5 of the Revenue and Taxation Code received by a nonresident. . . . [Emphasis added.]

Any reasonable allocation must be based on the facts and circumstances of each case.¹⁰ The most reasonable method here appears to be to multiply the compensation by a ratio of California working days from the grant date to the vest date over the total working days anywhere during the same period.¹¹

Here, Taxpayer received two separate RSU grants which are distinguishable based upon the date of grant of each group. Taxpayer was granted the first group of RSUs while he was a California resident on *****. The second group was granted after Taxpayer ceased to be a California resident.

The second group of RSUs began to vest on *****while Taxpayer was a California resident, but the RSUs were not granted until *****. Since Taxpayer moved out of California on *****, he was a nonresident on the date of the grant of the second group of RSUs. However, he continued to perform services for ***** in California on an occasional basis between the grant date of *****and the vest date of *****.

Because the Taxpayer performed services for ***** in California between the date of grant and the date of vest for both the ***** and the ***** groups of RSUs, a portion of the RSUs is compensation for the performance of personal services in California and must be sourced accordingly.

The allocation method used must reflect the extent to which the income is compensation for the performance of personal services in California. The most reasonable method of determining the portion of the California source income from the RSUs here appears to be to calculate a ratio of the portion of days Taxpayer performed services in California. For the

¹⁰ *Appeal of James B. and Linda Pesiri*, 89-SBE-027, Sept. 26, 1989.

¹¹See Cal. Code Regs., tit. 18, § 17951-5(b).

RSUs that vested on *****, the numerator of the ratio would contain the number of days Taxpayer performed services for ***** in California from ***** through *****; the denominator would contain the total number of days Taxpayer performed services for ***** worldwide from ***** through the date the RSUs vested, *****. The remaining RSUs vested on a monthly basis so the numerator and denominator in the ratio would reflect the monthly vest date. For example, the first vest after ***** occurred on *****so the numerator of the ratio would contain the number of days Taxpayer performed services for ***** in California from ***** through *****.

For the **** grant, the first group of RSUs vested on *****, so the numerator of the ratio would be the number of days Taxpayer performed services for ***** in California from *****through *****, and the denominator would contain the total number of days Taxpayer performed services for ***** worldwide from *****through the date the RSUs vest, *****. The remaining RSUs vested on a quarterly basis, so the numerator and denominator in the ratio would reflect the quarterly vest date. For example, the first vest after *****would occur on *****, so the numerator of the ratio would contain the number of days Taxpayer performed services for ***** in California from *****through *****. This ratio would then be multiplied by the total amount of compensation recognized on the vesting date to determine the total amount of California source income. Although Taxpayer in this matter is not limited to using this method of calculating his California source income, this method has been determined to be a reasonable manner of allocation and appears to be the most reasonable method that can be used under this taxpayer's facts and circumstances.¹²

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

¹²Publication 1004; see Cal. Code Regs., tit. 18 § 17951-5(b).

Maria Brosterhous
Tax Counsel