

06-1609
Income
Signed 08/16/2007

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER 1 & PETITIONER 2,	ORDER
Petitioners,	
v.	Appeal No. 06-1609
AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION,	Account No. #####
Respondent.	Tax Type: Income
	Tax Year: 2004
	Judge: Chapman

Presiding:

Kerry R. Chapman, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER 1
PETITIONER 2

For Respondent: RESPONDENT REPRESENTATIVE 1, Assistant Attorney General
RESPONDENT REPRESENTATIVE 2, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to the provisions of Utah Code Ann. §59-1-502.5, on August 9, 2007.

On November 21, 2006, Auditing Division (“Division”) issued a Statutory Notice of Audit Change (“Statutory Notice”), in which assessed \$\$\$\$ in additional income tax, plus interest, to the Petitioners for the 2004 tax year. No penalties were imposed. The Petitioners have asked that the entire assessment, including interest, be abated. The Division asks the Commission to sustain its assessment of tax and leaves it to the Commission’s discretion whether any portion of interest should be waived.

APPLICABLE LAW

Utah Code Ann. §59-10-117 provides that certain items that comprise federal adjusted gross income are considered to be derived from Utah sources and, as a result, are included in Utah state taxable income, pertinent parts as follows:

(1) For the purpose of Section 59-10-116, federal adjusted gross income derived from Utah sources shall include those items includable in federal "adjusted gross income" (as defined by Section 62 of the Internal Revenue Code) attributable to or resulting from:

...

(b) the carrying on of a business, trade, profession, or occupation in this state.

(2) For the purposes of Subsection (1):

(a) Income from intangible personal property, including annuities, dividends, interest, and gains from the disposition of intangible personal property shall constitute income derived from Utah sources only to the extent that such income is from property employed in a trade, business, profession, or occupation carried on in this state.

...

UCA §59-1-401(11) authorizes the Commission to waive penalties and interest upon a showing of reasonable cause.

DISCUSSION

The Division determined that the Petitioners did not pay Utah income tax on \$\$\$\$ in gains realized from the sale of stock that PETITIONER 1 obtained through a nonqualified stock option granted by his Utah employer. Two issues arise in this matter: 1) whether the Petitioners are liable for Utah income tax on the gains, even though the stock was sold after the Petitioners moved from Utah and had established domicile in STATE; and if yes, 2) whether reasonable cause exists to waive any or all of the interest that accrued on the additional tax.

Nonqualified Stock Options. The Petitioners were Utah residents from 1994 until March 2004, at which time they moved to and became domiciliaries of STATE. During the period the Petitioners

lived in Utah, PETITIONER 1 was employed by COMPANY A. (“COMPANY A”). In 1999, COMPANY A granted PETITIONER 1 a nonqualified stock option “as a separate incentive in connection with his . . . employment and not in lieu of any salary or other compensation for his . . . services[.]”¹ By April 5, 2002, the stock option had fully vested. PETITIONER 1 sold a portion of the shares obtained through the stock option prior to moving from Utah and paid Utah income tax on the gains received. PETITIONER 1, however, did not sell the remainder of the shares until June 2004, several months after the Petitioners moved to STATE. It is the gain realized on the shares sold in June 2004 that are at issue in this appeal.

The Division contends that the gain on these shares is income that is attributable to PETITIONER 1’s employment in Utah and, as a result, is subject to Utah taxation pursuant to Section 59-10-117. For this reason, the Division requests that the Commission sustain its assessment of additional Utah income tax. Because the Petitioners have already paid tax on the income at issue to STATE, the Division proffers that the Petitioners would be entitled to file an amended STATE tax return and claim a credit for the taxes due to Utah, as described in STATE Individual Income Tax Ruling ITR 02-5.

The Petitioners ask that the Commission not impose the additional Utah tax because the Commission’s instruction booklet does not clearly instruct a taxpayer how to treat gains when the taxpayer earns the stock option in one state and sells the stock after changing his or her domicile to another state. The Petitioners also state that they will not be entitled to a credit of the full amount of Utah taxes against their STATE tax liability because the STATE tax rate is lower than the Utah tax rate.

The Commission does not find the Petitioners’ arguments to be persuasive. Because the shares at issue were obtained from PETITIONER 1’s Utah employer “as incentive in connection with his employment” in Utah, the Commission finds that the gains at issue are “attributable to or resulting from”

1 Division’s Exhibit 4 – COMPANY A Nonqualified Stock Option Agreement, Appendix A, para.

PETITIONER 1 carrying on his profession in Utah. For these reasons, the Commission finds that the gains qualify as Utah source income pursuant to Section 59-10-117, even though PETITIONER 1 may have sold the shares after the Petitioners changed their domicile from Utah to STATE.² Accordingly, the Commission sustains the Division's assessment of additional income tax to the Petitioners.

Interest. The Petitioners paid the assessment on or around May 10, 2007, soon after being told at the April 26, 2007 Status Conference ("Status Conference") that they could stop the accrual of interest by paying the assessment. The Petitioners ask the Commission to waive the interest that accrued prior to their payment of the taxes for several reasons, including: 1) the Commission's instruction booklets do not provide guidance concerning the stock option circumstances at issue in this matter; 2) the Division did not provide the Petitioners any clear rulings addressing the stock option circumstances at issue until May 2007; 3) although the Division first contacted the Petitioners in early 2006 concerning the assessment, the Commission unreasonably extended the audit and appeals process, thus leading to additional interest, by not issuing a Statutory Notice until November 21, 2006 and not holding a hearing until August 9, 2007; and 4) when the Petitioners met personally with several Division employees on September 28, 2006, PETITIONER 1 proffers that he was told that if he paid the taxes in dispute, he could not appeal.

The Commission has determined that reasonable cause to waive interest pursuant to Section 59-1-401(11) exists if the interest arises due to Tax Commission error. The Commission cannot include every possible tax situation in its instruction booklet and is not required to provide case law a taxpayer to prove that

1.

2 This conclusion is consistent with the findings of other jurisdictions, which have held that the compensation received from stock options remains source income from the state where it was earned, notwithstanding the change of domicile of the employee prior to vesting or exercise. See *McBroom v. Dep't Revenue*, 969 P.2d 380 (Or. 1998); *Michaelson et al. v. New York State Tax Commission*, 496 N.E.2d 674 (N.Y. Ct. App. 1986). This conclusion is also consistent with a prior Commission ruling in *xxxxx v. Auditing Division*, USTC Appeal No. 05-0835 (November 20, 2006).

an assessment of taxes is correct. In fact, UCA §59-10-543 specifically provides that a taxpayer has the burden of proof concerning an assessment. Furthermore, the Commission does not find the length of time that expired during the audit and appeals processes to be unusual. In the six months prior to the Division issuing its Statutory Notice in November 2006, it appears that the Division and the Petitioners met at least twice to exchange information and to try to resolve the issue. Once the Petitioners submitted their Petition for Redetermination on December 19, 2006, a Status Conference was scheduled for April 26, 2007. At the Status Conference, it was decided to schedule an Initial Hearing, which was held on August 9, 2007. For these reasons, the Commission does not find that reasonable cause exists to waive interest for any of the first three arguments described above.

The fourth argument, however, concerns the Petitioners' interpretation of information received from Division personnel at a September 28, 2006 Division conference, which the Petitioners attended in person. PETITIONER 1 states that at the Division conference, he asked about paying the disputed tax liability to stop the accrual of interest, but was told by TAX COMMISSION EMPLOYEE, an employee of the Division, that he would not be able to appeal the disputed taxes if he paid them. The Division does not contest PETITIONER 1's memory of this meeting and the statements made to him.

Because the Division conference occurred prior to the November 21, 2007 issuance of the Statutory Notice, payment of the disputed taxes in September 2006 would have resulted in the Division not issuing its Statutory Notice. If the Division had not issued a Statutory Notice, no assessment would have existed to give rise to the appeal rights authorized under UCA §59-10-525. Accordingly, it appears that the Division properly informed the Petitioners about the appeal rights afforded under Section 59-10-525.

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Nevertheless, appeal rights concerning income tax are also afforded under UCA §§59-10-531 and 59-10-532, where a taxpayer may pay a disputed tax for which no assessment has been issued, thus stopping the accrual of interest, and subsequently request a refund of the amount paid. The Division admits that it has no evidence to suggest that Division employees told the Petitioners of this alternative appeal route. Given these circumstances, it appears that the Division did not inform the Petitioners of all appeal options and particularly the option that would have allowed them to pay the disputed tax, stop the accrual of interest, and still retain their appeal rights.

Because the Petitioners believed that they could not pay the tax and pursue their appeal rights until the April 26, 2007 Status Conference, and because the Petitioners paid the assessment within two weeks of Status Conference, the Commission finds that reasonable cause exists to waive that portion of the interest that accrued during the period beginning on September 28, 2006 and ending on April 26, 2007. The Commission sustains the remainder of the interest that accrued and was paid.

DECISION AND ORDER

Based upon the foregoing, the Commission sustains the Division's assessment of additional income tax for the 2004 tax year. Concerning the assessment of interest, the Commission finds reasonable cause to waive that portion of interest that accrued during the period beginning on September 28, 2006 and ending on April 26, 2007. The remainder of interest that accrued is sustained. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division

Appeal No. 06-1609

210 North 1950 West
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2007.

Kerry R. Chapman
Administrative Law Judge

BY ORDER OF THE UTAH STATE TAX COMMISSION.

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this _____ day of _____, 2007.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Notice: If a Formal Hearing is not requested as discussed above, failure to pay any remaining balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.

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