03-0613
AUDIT
SIGNED 10-26-2004

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER 1 & PETITIONER 2, Petitioners, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**ORDER** Appeal No. 03-0613 Account No. ##### Tax Type: Income Tax Judge: Phan

Presiding:
Jane Phan, Administrative Law Judge

Appearances:
For Petitioner: PETITIONER REP, Attorney at Law
For Respondent: RESPONDENT REP, Assistant Attorney General

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 November 12, 2003. On December 15, 2003, the parties submitted reply briefs or memoranda as well as Proposed Findings of Fact and Conclusions of Law[1] which were considered in this decision.

The matter before the Commission is Petitioner's appeal of an audit deficiency of additional Utah individual income tax and interest for tax year 1999. The Statutory Notice of Audit Change had been issued by Respondent on March 19, 2003, and was timely appealed by Petitioner on April 16, 2003.

[1]This decision is based extensively on the parties' proposed findings.

RELEVANT FACTS

1. The PETITIONERS were domiciled in Utah for income tax purposes as early as 1977 through at least November 1998.

2. Until June 1999, PETITIONER 1 had been the Chief Executive Officer since 1992 and the Chairman of the Board of Directors since 1995 of COMPANY A ("COMPANY A"). COMPANY A was a STATE 1 corporation headquartered in Utah.

3. Late in 1998, the PETITIONERS sold their Utah residence to their son and in December 1998 they moved to a residence in CITY 1 STATE 2. They assert that the STATE 2 residence became their primary domicile. This contention was not refuted by Respondent and the audit was based on the PETITIONERS being nonresidents of Utah with Utah source income taxable to Utah during 1999.

4. Although residing primarily in STATE 2, PETITIONER 1 continued as the Chief Executive Officer and Chairman of COMPANY A until June 24, 1999. From January 1999 through June 1999, COMPANY A remained headquartered in CITY 2[2] and it had no offices, businesses, stores, or property in the state of STATE 2.[3] Although he supervised employees who continued to work in CITY 2,[4] PETITIONER 1 maintains that he worked mostly from his STATE 2 residence or STATE 3 residence and that he spent only 13 days in Utah for his work with COMPANY A. He continued to be provided an office in the CITY 2

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[2]See Respondent's Exhibits R-12 and R-13.

[3]See Respondent's Exhibit R-9.

[4]During 1999, PETITIONER supervised the following COMPANY A employees whose offices were in CITY 2, Utah: PERSON A, Chief Operating Officer - Strategy and Development; PERSON B, Chief Legal Officer; PERSON C, Chief Operating Officer - Procurement and Logistics; and PERSON D, Chief Financial Officer.

COMPANY A headquarters. He used company letterhead with only the CITY 2 1ddress.[5]

5. During the first half of 1999, COMPANY A was in the process of being merged into COMPANY B. On August 2, 1998, the board of directors of COMPANY A and COMPANY B had announced and approved a plan of merger. On November 12, 1998, the shareholders of COMPANY A and COMPANY B ratified the plan of merger. On June 23, 1999, the merger was granted regulatory approval and the merger became final. COMPANY B was headquartered in STATE 4 and after the merger COMPANY A headquarters employees retained by COMPANY B were transferred to STATE 4.

6. It was clear to Petitioner that COMPANY B' management did not want to employ Petitioner other than for a brief consulting period after the merger was effective and the PETITIONERS did not plan on going to STATE 4. Petitioner did provide some consulting services to COMPANY B after the effective date of the merger, but this income was not included as Utah source income and was not taxed by Respondent .

7. PETITIONER 1 and his spouse, PETITIONER SPOUSE, (the "PETITIONERS") filed a 1999 Utah Individual Income Tax Return as nonresidents and reported $$$$$ as Utah Source Income.[6]

8. The Tax Commission issued a Statutory Notice of Audit Change revising Utah Source Income to $$$$$, and showing a net Utah income tax deficiency of $$$$$, excluding interest but after application of

[5] See Respondent's Exhibits R-5 and R-6.

[6] See Joint Exhibit J-4.

credits. No penalty was assessed.[7]

[7] See Joint Exhibit J-1.

9. After the issuance of the Audit Deficiency, upon reviewing the matter it was the PETITIONERS' position that the Amended W-2 issued to them by COMPANY A was incorrect. They filed an amended 1999 Utah Individual Income Tax Return requesting a refund of $$$$$ and reporting only $$$$$ as Utah source income.[8] This was based on their determination that for the period of January 1, 1999 through June 24, 1999, although working for COMPANY A, PETITIONER 1 was physically in Utah only 12.2% of the time (13 out of 106 days) and so should pay tax on 12.2% of certain items of regular compensation consisting of the non-deferred regular pay, bonus, group term life insurance and personal use of car and plane. It was Petitioner's position that no portion or percentage of the remaining items of compensation were subject to Utah tax.

10. PETITIONER 1 received a number of different items of compensation from COMPANY A in 1999, which, net of contributions to qualified retirements plans, totaled $$$$$. This compensation was classified by COMPANY A as wages for purposes of federal income tax, FICA and Medicare purposes as required by IRC § 3121.[9] The compensation can be itemized within three general categories as follows, and will be discussed in detail below:

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[8] See Joint Exhibit J-3.

[9] See Joint Exhibit J-7, "1999 Amended W-2".

ITEMS OF COMPENSATION

Deferred Compensation:

- Special Long Range Retirement Plan "SLRRP":	$$$$$
- Non-qualified Stock Options:	$$$$$
- Stock Dividend (on restricted stock):	$$$$$
- Restricted Stock LTIP & PIP	$$$$$
- LTIP (cash bonus):	$$$$$

Severance Pay:

- Severance (base and bonus):	$$$$$[10]
- Golden Parachute gross-up:	$$$$$
- Term (Accumulated)Vacation:	$$$$$

Regular Compensation:

- Regular Pay:	$$$$$[11]
- Bonus:	$$$$$[12]
- Accrued Vacation:	$$$$$
- Holiday Pay:	$$$$$
- Personal Holiday Pay:	$$$$$
- Personal Use of Car and Plane	$$$$$
- SERP Company Contribution	$$$$$
- Group Term Life	$$$$$

[10] Most of this sum, all but $$$$$, was contributed to a qualified plan "SERP" and was deducted from the Utah source income as indicated in this paragraph.

[11] See footnote 10.

[12] See footnote 10.

Total Income:	$$$$$
Less Contributions to SERP	($$$$$)
Total Utah Source Income at Issue:	$$$$$

11. COMPANY A issued a 1999 W-2 and amended 1999 W-2 listing as Utah income all of the lump sum SLRRP payment, a portion of the company car and a portion of PETITIONER's wages based upon days in STATE 2 and days out of Utah. COMPANY A pro-rated the severance pay 97.95% to Utah and 2.05% to STATE 2 based upon days worked from PETITIONER's continuous employment with COMPANY A beginning in 1977 and ending in 1999.[13]

DEFERRED COMPENSATION

12. The are five types of deferred compensation which Respondent has determined to be Utah source income.

A. Non-qualified Stock Options:

[13] See Respondent's Exhibit R-5, Joint Exhibit J-7.

A portion of the deferred compensation received by PETITIONER in 1999 from COMPANY A included income from the exercise of non-qualified stock options which were granted in 1995 through 1997. Of the ##### options granted ##### options vested in 1998 and 1999 under the regular provisions of the Stock Option Plan. Pursuant to the stock options the vesting of options accelerated based on a change of control.[14] Based on the option, ##### vested on November 12, 1998 when the merger was approved by the shareholders. But for the change in control, these options would have been contingent on PETITIONER 1's continued employment and would have vested pursuant to the regular vesting schedule in staggered amounts in February 1999, February 2000 and February 2001. The final ##### options vested on June 22, 1999 when the merger received regulatory approval. Without the contemplated change in control these options would have required continued employment of PETITIONER 1 and vested in February 2000 and February 2001. PETITIONER 1 received compensation from COMPANY A in 1999 from the options in the amount of $$$$$ which was reported on his 1999 W-2 as wage income.

B. Restricted Stock from Performance and Incentive Plan and Long-term Incentive Plan: PETITIONER 1 participated in 1996 through 1998 in COMPANY A' Long-term Incentive Plan ("LTIP") under which he was awarded stock based on the financial performance of COMPANY A during that three year period.[15] PETITIONER 1's stock awarded under LTIP

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[14] See Joint Exhibit, J-17.

[15] See Joint Exhibit J-18.

was vested on April 1, 1999.[16] PETITIONER 1 also was awarded restricted stock as a bonus relating to the financial performance of the company in 1998 from the COMPANY A Performance Incentive Plan ("PIP") He received the PIP bonus stock in 1999 when it was determined that COMPANY A had satisfied its 1998 performance goals. The performance of COMPANY A in 1999 had no impact on the PIP and LTIP awards due PETITIONER in 1999. PETITIONER surrendered the PIP and LTIP shares on or about August 31, 1999 under the terms of the Merger Agreement and recognized the sum of $$$$$ on his 1999 as W-2 wage income.

C. LTIP Cash Bonus

In addition to stock that PETITIONER received under LTIP, PETITIONER received a cash bonus in the amount of $$$$$, which was represented as wages on his 1999 W-2.

D. Dividend on Restricted Stock

The dividend of $$$$$ declared on the restrictive stock to be awarded under the PIP and LTIP plans was paid to PETITIONER as part of the bonus and was reported by COMPANY A as wages on his 1999 W-2.

[16]Petitioner maintains that the until the stock vested in April 1999 the stock was subject to forfeiture if employment was terminated or if stated performance goals were not met.

E. Special Long Range Retirement Plan

On November 1, 1994, PETITIONER entered into an employment agreement ("1994 Employment Agreement") with COMPANY A that paid him deferred compensation for his employment services under a Special Long Range Retirement Plan ("SLRRP").[17] The SLRRP (net of tax) was funded in 1997 by $$$$$ contribution by the company to a rabbi trust.[18] The SLRRP benefits vested over time and payments would begin on October 31, 2002, unless preceded by certain events, such as the termination of employment, the death or disability of PETITIONER 1, or a change of control of COMPANY A.[19] As of December 1998, PETITIONER 1 was vested in 36% of the benefits under SLRRP. The Second Amendment to the 1994 Employment Agreement, dated July 29, 1997, ("Second Amendment")[20] provided that the SLRRP benefit would be fully vested and the payments due would be made in a lump sum payment upon a change of control. COMPANY A calculated the SLRRP lump sum payment assuming payout of state income tax and included the SLRRP payment as Utah source income. On July 23, 1999, PETITIONER, COMPANY A and COMPANY B entered into an Agreement And Release that acknowledged the payment of PETITIONER's SLRRP

[17] See Joint Exhibit, J-8.

[18] The purpose of the rabbi trust was to provide immediate funding of the future SLRRP benefit while deferring PETITIONER's income tax recognition under IRC § 83 until the benefit was paid.

[19] The employment agreement also provided that the undistributed SLRRP benefits, including vested and unvested benefits were forfeited if the executive competed with the Company.

[20] See Joint Exhibit, J-11.

benefits and provided the termination of the rabbi trust that had funded the SLRRP benefits.[21] The Agreement and Release makes no condition for future services of PETITIONER.

SEVERANCE PAY

13. There were three different items of compensation under the category of severance pay that Respondent determined to be Utah source income. Included in the severance package were basic severance pay, golden parachute gross-up payment and term vacation pay.

14. The amount and type of severance was predetermined by an agreement entered into between PETITIONER 1 and COMPANY A. On July 25, 1996, PETITIONER 1 had entered into an employment agreement with COMPANY A ("Change of Control Agreement") that gave him the right to certain payments upon change of control. The Change of Control Agreement was entered into in 1996 to "encourage the Executive's [PETITIONER 1] full attention and dedication to the Company currently . . . ."[22]

[21] See Joint Exhibit J-14.

[22] See Joint Exhibit J-9, page 1.

15. As a result of the merger agreement entered into by the Board of Directors of COMPANY B and COMPANY A, COMPANY B, COMPANY A and PETITIONER 1 entered into a Termination and Consulting Agreement on August 2, 1998 (the "Termination and Consulting Agreement"), which reiterated the deferred compensation and severance pay that would become due PETITIONER 1 because of the change of control.[23] The terms of the payment of these benefits did not differ from the terms and conditions already existing under the previous employment agreements and Change and Control Agreement of PETITIONER.[24] In addition the agreement specified that payment was not contingent upon PETITIONER 1 performing future services nor was it contingent on PETITIONER 1 meeting the provisions of the non-compete clause.[25] The

[23] The Termination and Consulting Agreement in paragraph 11(e) provided that it "shall supersede any other agreement between the parties with respect to the subject matter hereof, including without limitation the Employment Agreement and Change of Control Agreement."

[24] See Joint Exhibit J-13.

[25] The Termination and Consulting Agreement did not make any of the payments due PETITIONER upon a change in control subject to future services. In paragraph 5 regarding non-competition with COMPANY B under the Consulting Agreement, the Termination and Consulting Agreement stated as follows: "In no event shall an asserted violation of the provisions of section 5 [non-competition] constitute a basis for deferring or withholding any amounts otherwise payable to the executive under this agreement." Id.

three types of severance pay are as follows: **A. Basic Severance and Bonuses**

Upon the closing of the merger in 1999, the Change of Control Agreement required COMPANY A to pay PETITIONER 1 three times his annual salary and his annual estimated bonus in a total amount of amount $$$$$. Most of this amount, $$$$$, was contributed to a qualified retirement plan and is not included in the Division's determination of Utah source income.

B. Golden Parachute Gross-Up

The Change of Control Agreement also provided PETITIONER a gross-up payment on the federal excise taxes and associated federal and state income taxes that PETITIONER would be responsible for as a result of the golden parachute requirements under 26 U.S.C. § 4999.

C. Term Vacation

As a result of his separation from COMPANY A in 1999, PETITIONER received payment for his term vacation that he had accumulated over the many years of his employment with COMPANY A in the amount of $$$$$.

APPLICABLE LAW

The relevant statutes are:

1. Utah Code Ann. § 59-10-117 (1996)

(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):

(c)salaries, wages commission, and compensation for personal services rendered outside this state shall not be considered to be derived from Utah sources.

> (f) If a trade, business, profession, or occupation is carried on partly within and partly without this state, items of income, gain, loss, and deductions derived from or connected with Utah sources shall be determined in accordance with the provisions of Section 59-10-118.

2. Utah Code Ann. § 59-10-118 (1996)

(13) Compensation is paid in this state if:

* * *

> (b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or
>
> (c) some of the service is performed in the STATE 1nd: (I) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state . . . .

ANALYSIS

The compensation paid in 1999 to PETITIONER by COMPANY A is best analyzed in three general categories: regular pay, deferred compensation and severance pay.

REGULAR PAY

Utah Code Ann. Sec. 59-10-117 indicates that salaries, wages, commissions, and compensation for personal services rendered outside this state shall not be considered to be derived from Utah sources. The section also provides income is derived from Utah sources if it is attributable to, or resulting from, "the carrying on of a business, trade, profession, or occupation in this state." Utah Code Ann. Sec. 59-10-117(1)(b) & (2)(c). The statute further indicates that when the trade, business, occupation or profession is carried on partly within and partly without this state Section 59-10-118 governs which items are Utah source income. See Utah Code Ann. Sec. 59-10-117(2)(f). Utah Code Ann. Sec. 59-10-118 apportions business income between Utah and non-Utah sources.

PETITIONER 1's received regular compensation from COMPANY A for the period from January 1, 1999 through June 24, 1999. The Auditing Division has chosen not to contest the fact that PETITIONER 1 was a nonresident of Utah during that period.[1] Thus, PETITIONER 1's tax liability is determined by Section 59-10-116. Although that statute is not a model of clarity, it is undisputed that the practical effect is to impose a tax only on taxable income derived from Utah sources.

Section 59-10-117 provides rules for determining what income is derived from Utah sources for purpose of Section 59-10-116. PETITIONER 1 was an employee and officer of COMPANY A during 1999. He was not conducting a trade or business. The income in question is salary and other compensation for personal services rendered to his employer, COMPANY A. Section 59-10-117(c) provides that "[s]alaries, wages, commissions, and compensation for personal services rendered outside this state shall not be considered to be derived from Utah sources."

The evidence is uncontroverted that PETITIONER 1 was present in Utah for only 13 days from January 1 through June 24, 1999. On those days he rendered services inside the state. The rest of the

[1] The Commission has previously issued a letter ruling to PETITIONER 1. That letter ruling was premised on the facts provided at the time. If the material facts are different than they were represented to be, the ruling would not be valid. Although the Division apparently believes the facts may not have been exactly as represented, they have not challenged them in this hearing.

time, he rendered services outside the state. The evidence is clear. The result should be clear. PETITIONER 1 is taxable only on the portion of his 1999 regular compensation attributable to those 13 days. Simply put, there is one scheme for determining the source of income from a trade or business. There is another scheme for determining the source of income from salaries, wages and other compensation. The income in question is salary and compensation income and we must use the statutory provision that applies. The Commission agrees with Petitioner that only 12.2% of the regular pay items earned during the period of January 1, through June 1999 are taxable as Utah source income.

DEFERRED COMPENSATION

The largest portion of the income at issue in this matter has been categorized under Deferred Compensation as the Special Long Range Retirement Plan ("SLRRP") payments and the Non-qualified Stock Options. Petitioner points out that the SLRRP payments, but for the merger or one of the other specified circumstances which are not applicable in this matter, would not have begun until October 31, 2002. Petitioner argues that the accelerated vesting and payment to PETITIONER 1 of his SLRRP benefits was consideration for his relinquishment of his rights to future employment under his Employment and Change of Control Agreements.

Respondent counters that the early vesting was not in consideration of the relinquishment of rights to future employment but merely paying Petitioner the items and amounts for which he was entitled in the event of a change of control pursuant to the Second Amendment to the 1994 Employment Agreement, dated July 29, 1997, ("Second Amendment")[2] and an Amended and Restated Employment Agreement dated

[2]See Joint Exhibit 11.

December 9, 1997 (“Change of Control Agreement”).[3] Both agreements provided that the SLRRP benefit would be fully vested and payments due would be made in a lump sum payment upon change of control. Upon reviewing the Second Amendment and Termination Agreement in this matter , the Commission concurs with Respondent that the accredited payment was not made to compensate Petitioner for giving up some future rights, but instead as payments for which he was entitled pursuant to the agreements he had enxtered into with COMPANY A in Utah while a resident of Utah, for work that he was performing in Utah. The Second Amendment and Change of Control Agreement indicates that the SLRRP is designed to “encourage key executives to remain with the Company on an extended basis, have undivided loyalty to the Company, and not develop conflicts of interest by affiliating with the Company’s competitors.”[4] The Termination and Consulting Agreement entered into on August 2, 1998,[5] merely summarizes the payments and stock to which Petitioner had already been entitled pursuant to the prior employment agreements and stock option plans. It does not support Petitioner’s contention that the accredited vesting of the SLRRP and other types of compensation was payment for Petitioner giving up his right to future employment.

The Non-qualified Stock Options were issued pursuant to various stock option agreements and the agreements specifically indicated that the unvested portion of the options would vest and become immediately exercisable upon a change of control. They were issued to encourage employees to remain

[3]See Joint Exhibit 12.

[4]See Joint Exhibit 11, pg. 2.

[5]See Joint Exhibit 13.

focused on improving shareholder value.[6] The Commission can find no support for Petitioner's assertion that the accelerated vesting of the stock options was consideration for his relinquishment of PETITIONER 1's rights to future employment. They were issued with the provision that there would be the accredited vesting as part of the compensation package paid to PETITIONER 1 while a resident of and employed in Utah.[7] The income Petitioner received during 1999 from the Non-qualified Stock Options is Utah source income and taxable to Utah.

The other items which are under the category of deferred compensation are also Utah Source income. Petitioner received restricted stock under an LTIP and PIP performance award plans. This stock was issued to him for meeting certain stated performance goals during years prior to 1999 when Petitioner was a Utah resident.

[6] See Joint Exhibits 15-17.

[7] Respondent points out that both STATE 5 and STATE 6 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. Respondent cites McBroom, 14 STATE 5 Tax 23 (1997) and Michaelson v. STATE 6 State Tax Comm'n, 496 N.E. 2d 674 (Ct. App. (X) 1986).

SEVERANCE PAY

The last category of compensation is the various items of severance pay. As part of his severance pay PETITIONER 1 received three times his annual salary and bonus, as well as a gross-up amount for the excise tax and federal income tax that resulted from the payment of the salary and bonus. Respondent argues that PETITIONER 1 was entitled to these payments pursuant to the terms of the Change of Control Agreement which he had entered into with COMPANY A in 1996. Respondent indicates that the purpose of these benefits as stated in the 1996 Change of Control Agreement was to "encourage the Executives's full attention and dedication to the Company currently and in the event of any threatened or pending Change of Control."[8]

Petitioner's representative argues that the severance pay and bonus was paid to compensate PETITIONER 1 for his relinquishment of his rights to future employment under his employment and Change of Control Agreements. Petitioner points out that had there been future employment, it would not have been in Utah. After the merger with COMPANY B the COMPANY A headquarters in Utah was closed and operations transferred to STATE 4.

The Commission determines that the items of Severance Pay were amounts which Petitioner earned while a Utah resident working in Utah and are Utah Source income taxable under Utah Code Ann. Sec. 59-10-117. The severance payment agreements were entered into in 1996, so that PETITIONER 1 could focus his attention on what was best for COMPANY A. He was entitled to and had earned the severance payments

[8]See Joint Exhibit 9, pg. 1.

contingent on his terminating employment due to the merger, prior to his leaving the state of Utah.

ORDER

Based upon the foregoing, the Commission affirms the Division's Statutory Notice of Deficiency as it pertains to the deferred compensation and severance pay items. Respondent is hereby ordered to adjust its audit assessment pertaining to the regular pay items consistent with this decision. 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
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 ____________________________, 2004.

____
Jane Phan
Administrative Law Judge

BY ORDER OF THE UTAH STATE TAX COMMISSION.

Appeal No. 03-0613

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

Pam Hendrickson
Commissioner Chair

R. Bruce Johnson
Commission

Palmer DePaulis
Commissioner

Marc B. Johnson
Commissioner

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