NO. CV 11 6010197

JEFFERSON ALLEN, EVITA ALLEN	:	SUPERIOR COURT
	:	TAX SESSION
v.	:	JUDICIAL DISTRICT OF
	:	NEW BRITAIN
KEVIN SULLIVAN, COMMISSIONER OF REVENUE SERVICES	:	APRIL 29, 2015

MEMORANDUM OF DECISION

The plaintiffs, Jefferson and Evita Allen (the Allens) filed this appeal pursuant to General Statutes § 12-730 contesting the commissioner of revenue services' (commissioner) disallowance of the plaintiffs' claims for a refund of individual income taxes for the taxable years of 2002, 2006 and 2007. Both the Allens and the commissioner filed cross motions for summary judgment.

The two issues in this appeal are:

1) whether the Allens timely filed their claim for refund of taxes paid for the taxable year of 2002 and

2) whether the state of Connecticut has the right to tax a nonresident on income he or she realizes from the exercise of nonqualified stock options granted for services rendered in Connecticut.

The parties have entered into the following stipulations:

As to taxable year 2002

1. The plaintiffs were required to file and pay their Connecticut individual income tax for the taxable year of 2002 by April 15, 2003.

2. On or about March 8, 2007, the plaintiffs filed with the commissioner a Connecticut Nonresident and Part-Year Resident Income Tax Return for the taxable year of 2002 reporting income from Connecticut sources in the amount of $15,946,626 and paid a Connecticut income tax in the amount of $717,307.

3. On or about October 13, 2009, the plaintiffs filed an Amended Connecticut Income Tax Return for Individuals with the commissioner and requested a refund of their Connecticut individual income tax for taxable year 2002 in the amount of $717,307.

4. The last day that the plaintiffs could have filed for a refund of their Connecticut individual income tax for taxable year of 2002 was April 15, 2006, pursuant to General Statutes § 12-732.

5. The commissioner denied the plaintiffs' request for a refund and issued a final determination letter for taxable year 2002 on or about June 11, 2013.

See joint stipulation of facts, Entry No. 150.

The plaintiffs claim that income for the year 2002, originally reported as Connecticut source income, was income from the exercise of nonqualified stock options erroneously reported as Connecticut source income. In fact, the Allens were nonresidents of Connecticut at the time the options were exercised. The reason for this claim is that

Mr. Allen, formerly the president and chief financial officer of Tosco Corp., was given nonqualified stock options in the taxable year of 2002 which he subsequently exercised when he was a nonresident of Connecticut.

The commissioner's main reason for denying the plaintiffs' refund request on their 2002 tax return is that the plaintiffs failed to file their claim for a tax refund within the statute of limitations in General Statutes § 12-732.

Section 12-732 (a) (1) provides, in relevant part, as follows:

"If any tax has been overpaid, the taxpayer may file a claim for refund in writing with the commissioner within three years from the due date for which such overpayment was made, stating the specific grounds upon which the claim is founded . . . . Failure to file a claim within the time prescribed in this section constitutes a waiver of any demand against the state on account of overpayment."

Recognizing that the plaintiffs filed their claim for a refund for the 2002 tax year beyond three years from April 15, 2003, the commissioner maintains that, on this basis alone, the plaintiffs are not entitled to a refund for taxes paid for the tax year of 2002.

The plaintiffs argue that the statute of limitations should not run from "within three years from the due date for which such overpayment was made . . . ." The plaintiffs contend that because the commissioner conducted an audit of the plaintiffs' tax returns, the statute of limitations should run from the completion of the audit, with an opportunity for the plaintiffs to appeal to the appellate division of the Department of Revenue Services before seeking a refund.

The plaintiffs have not identified any authority that would provide an exception to § 12-732 and permit the plaintiffs to wait until the final determination of the commissioner following an audit. Section 12-732 is clear on its face that where, as here, the taxpayer claims to be entitled to a refund of taxes, that such a claim for refund must be made in writing to the commissioner within three years from the due date of April 15, 2003, i.e., April 15, 2006.[1]

It is well settled that Connecticut is immune from suit unless it has statutorily waived its sovereign immunity. DaimlerChrysler Corp. v. Law, 284 Conn. 701, 711, 937 A.2d 675 (2007). It is also well established that the failure to comply with the statute of limitations governing claims for refund deprives the Court of subject matter jurisdiction. See Chatterjee v. Commissioner of Revenue Services, 277 Conn. 681, 691, 894 A.2d 919 (2006). On this basis, the court grants the commissioner's motion for summary judgment as to the plaintiffs' claim for a refund of the income taxes paid for the year of 2002.

1 General Statutes § 1-2z, also known as the plain meaning rule, provides as follows: "The meaning of a statute shall, in the first instance, be ascertained from the text of the statute itself and its relationship to other statutes. If, after examining such text and considering such relationship, the meaning of such text is plain and unambiguous and does not yield absurd or unworkable results, extratextual evidence of the meaning of the statute shall not be considered."

As to taxable years 2006 and 2007

On the second issue, the plaintiffs acknowledge that Mr. Allen's employers compensated him with nonqualified stock options earned while he was a resident of Connecticut. Nevertheless, the plaintiffs maintain that Mr. Allen was beyond the jurisdiction of the state of Connecticut to tax the income resulting from the exercise of the stock options since he was a nonresident of Connecticut at that point in time.

As to Taxable Year 2006

Mr. Allen was employed by Tosco Corp. from 1990 through 2001 as its president and chief financial officer. During this period of time, the plaintiffs were residents of the state of Connecticut. Mr. Allen was also a Connecticut resident while he was employed by Premcor, Inc. (Premcor) from January 1, 2005 through August 31, 2005 as chief executive officer. All of the services Mr. Allen performed for Premcor occurred in Connecticut. As part of his compensation with Premcor, Mr. Allen was granted certain nonqualified stock options for services performed for Premcor. It was stipulated between the parties that these nonqualified stock options had no readily ascertainable fair market value on the date they were granted to Mr. Allen. See Stip. ¶ 43. It was also stipulated that the plaintiffs were nonresidents of Connecticut in the taxable years of 2006 and 2007.

In the taxable year of 2006, Mr. Allen earned $43,360,812 of income from the exercise of nonqualified stock options granted to him by Premcor as compensation for services performed solely in Connecticut.

On or about April 4, 2007, the plaintiffs filed their 2006 original state tax return reporting income earned from the exercise of nonqualified stock options as income from Connecticut sources in accordance with Conn. Agencies Regs. § 12-711 (b)-18. Stip. ¶ 51.

On October 13, 2009, the plaintiffs filed their 2006 Amended Connecticut State Tax Return claiming a refund of all of the taxes paid for the taxable year of 2006. Stip. ¶ 52.

The audit division and the appellate division denied the plaintiffs' 2006 tax year claim for a refund on the basis that the income from the exercise of the nonqualified stock options were for compensation for services performed in Connecticut. A final determination letter was issued to the plaintiffs for the taxable year of 2006 on or about June 11, 2013. Stip. ¶ 56.

As to Taxable Year 2007

On April 11, 2008, the plaintiffs filed their Connecticut Nonresident and Part-Year Resident Income Tax Return for the taxable year of 2007 reporting income from Connecticut sources in the amount of $2,247,745. The plaintiffs paid a Connecticut income tax for the taxable year 2007 of $112,229. On or about October 13, 2009, the plaintiffs filed an Amended Connecticut Income Tax Return for Individuals seeking a refund of $112,229 for the taxable year of 2007.

The basis for the plaintiffs' claim of a refund of taxes paid on the 2007 Connecticut tax return is that Mr. Allen, as CEO of Premcor, received nonqualified stock options from Premcor during his period of employment from January 1, 2005 to August 31, 2005 when the plaintiffs were Connecticut residents and Mr. Allen's services for Premcor were performed in Connecticut. However, Mr. Allen was a nonresident of Connecticut when he exercised the options.

On October 12, 2012, the audit division denied the plaintiffs' claim for a refund for the taxable year of 2007 on the basis Mr. Allen received the income from the exercise of nonqualified stock options granted to him by Premcor as compensation for services performed in Connecticut. See Stip. ¶ 72.

Claims of the Parties

The plaintiffs argue that they should not be subjected to Connecticut income tax on the income realized upon the exercise of Mr. Allen's nonqualified stock options for two alternate reasons: (1) Conn. Agencies Regs. § 12-711 (b)-18 (a) is unconstitutional and (2) that the income derived by the exercise of the nonqualified stock options outside of the state of Connecticut by a nonresident of Connecticut is beyond the reach of Connecticut to tax.

Addressing the issue of whether Conn. Agencies Regs, § 12-711 (b)-18 (a) is unconstitutional, the plaintiffs recognize that General Statutes § 12-711 (c) (1)[2] authorizes the commissioner to issue rules and regulations to carry out the intent of the legislature as expressed in this statute. The authorization permits the commissioner to determine and apportion that income which is derived from Connecticut sources.

The plaintiffs make a constitutional argument that the Due Process Clause of the United States Constitution forbids the States from taxing extraterritorial values.[3]

The Due Process Clause of the Fourteenth Amendment to the U.S. Constitution prohibits the state of Connecticut from imposing a tax on the profits of a transaction taking place beyond it borders. See Chase Manhattan Bank v. Gavin, 249 Conn. 172, 184, 733 A.2d 782 (1999): "As a general principle, a State may not tax value earned outside its

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General Statutes § 12-711 (c) (1) provides as follows: "If a business, trade, profession or occupation is carried on partly within and partly without this state, as determined under rules or regulations of the commissioner, the items of income, gain, loss and deduction derived from or connected with sources within this state shall be determined by apportionment under such rules or regulations and the provisions of this subsection."

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See plaintiffs' 11/14/14 memorandum of law, pp. 3-4, citing MeadWestvaco Corp. v. Illinois, 553 U.S. 16, 19 (2008); Container Corp. of America v. FTB, 463 U.S. 159, 164 (1983); Allied-Signal, Inc. v. N.J., 504 U.S. 768, 777 (1992) and Mobil Oil Corp. v. Vt., 445 U.S. 425, 441-442 (1980).

borders." (Internal quotation marks omitted.) As discussed above, Mr. Allen's earning of compensation occurred in Connecticut.

In construing Conn. Agencies Regs. § 12-711 (b)-18 (a), as applied to the field of taxation, our courts have "long . . . held that when our tax statutes refer to the federal tax code, federal tax concepts are incorporated into state law. . . . [W]here incorporation of federal tax principles makes sense in light of the statutory language at issue, our prior cases uniformly have held that incorporation should take place." (Citations omitted; internal quotation marks omitted.) Berkley v. Gavin, 253 Conn. 761, 773, 756 A.2d 248 (2000).

In the present case, income earned in Connecticut is taxed pursuant to General Statutes § 12-700, regarding the imposition of tax on income of each resident of this state, and General Statutes § 12-701 (19) which describes "'adjusted gross income'" (AGI) to mean "the [AGI] of a natural person with respect to any taxable year, as determined for federal income tax purposes and as properly reported on such person's federal income tax return." Given the fact that the Connecticut AGI of a Connecticut resident begins with the taxpayer's federal AGI, it is appropriate to incorporate federal tax principles in so far as they relate to the taxation of and the valuation of nonqualified stock options. See Bell Atlantic NYNEX Mobile, Inc. v. Commissioner of Revenue Services, 273 Conn 240, 261, 869 A.2d 611 (2005): "We long have held that when tax statutes refer to the federal tax code, federal tax concepts are incorporated into state law. . . .” (Internal quotation marks omitted.) Notably, § 12-701 (19) provides such an express reference to the federal tax code.

On the federal level, nonqualified stock options are taxed as ordinary compensation because, pursuant to Internal Revenue Code (IRC) § 83 (a)-(b), nonqualified stock options result in additional taxable income to the recipient at the time that they are granted, provided that there is a market for the stock of the company and it has an ascertainable market value. However, if the value of the nonqualified stock options cannot be determined because there is no market for the company stock and its value cannot be determined, then under the IRC, it is not taxed until the stock options have been exercised.[4]

According to the U.S. Tax Court in Sheedy v. Commissioner, T.C. Memo. 2012-69 (2012): “Where a taxpayer receives a nonqualified stock option without a readily ascertainable fair market value, mere receipt of the option is generally a nontaxable event. See [IRC §] 83 (e) (3). Instead, the taxpayer is taxed upon his or her exercise of the option and receipt of the shares where two conditions are met: First, where the shares are transferred to the taxpayer such that he or she acquires beneficial ownership interest

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[4] 26 U.S.C. § 83 - Property transferred in connection with performance of services. See also Taxation of nonqualified stock options, Treasury Regulations § 1.83-7 (a)-(b).

therein. See [§] 1.83-3 (a) (1), Income Tax Regs. Second, where the shares are substantially vested in the taxpayer such that they are transferable or not subject to a substantial risk of forfeiture. See [§] 1.83-3 (b), Income Tax Regs. Where both conditions are met the taxpayer must recognize gross income in the amount by which the fair market value of the shares exceeds the exercise price paid to acquire them. See [§] 83 (a).” Both conditions in Sheedy have been met by Mr. Allen in the exercise of his nonqualified stock options.

When an employee exercises his or her nonqualified stock options and retains the stock received from exercising the options, the value of the stock is the difference between the market value of the stock on the date of the exercise and the value of the option price set out in the option agreement. See Commissioner v. Lo Bue, 351 U.S. 243, 249, 76 S. Ct. 800, 100 L. Ed. 1142 (1956). This difference in value is the amount of wages earned by the employee and reportable as income and the amount deducted by the employer as a business expense.

It is the commissioner’s position, pursuant to § 12-711 (b)-18 (a) of the regulations, that nonqualified stock options are taxable as ordinary income rendered for performing services to an employer if “during the period beginning with the first day of the taxable year of the optionee during which such option was granted and ending with the last day of the taxable year of the optionee during which such option was exercised

. . . the optionee was performing services within Connecticut." In other words, if Mr. Allen was granted the nonqualified stock options by his employers for services performed in Connecticut, at which time the stock options had no readily ascertainable fair market value, even though Mr. Allen had established residence outside Connecticut when he exercised his stock options, Connecticut had the right to tax the gain as Connecticut source income.

Contrary to the commissioner's position, the Allens contend that a stock option exercised beyond the borders of the state of Connecticut cannot be taxed because Connecticut would have no jurisdiction to tax a transaction occurring outside the state of Connecticut in violation of the Due Process Clause of the Fourteenth Amendment.

It is the Allens' position that the exercise of the stock options that were originally granted in Connecticut are only taxable in the jurisdiction where the stock options are exercised. However, neither party disagrees that the origination of the stock options was the granting of the options as a form of compensation to Mr. Allen for work performed in the state of Connecticut. It was also stipulated by the parties that, at the time of the granting of the nonqualified stock options, that there was no readily ascertainable fair market value on the date that they were granted. See Stip. ¶ 43.

As previously noted above, <u>Lo Bue</u> held that where there was no ascertainable fair market value on the date the stock options were granted, the taxable gain to the employee should be measured from the time the stock options were exercised. Commissioner v. Lo Bue, 351 U.S. 249.

In order to agree with the Allens that Connecticut has no jurisdiction to tax the proceeds of the exercise, one would have to conclude that the exercise of the stock options was not related to compensation but was in the nature of the sale of a capital asset.[5] If the exercise of the stock options were the payment of wages, the payment would have to relate back to the earning of the wages that took place in Connecticut. Otherwise, the exercise of the stock options taking place in another state would permit that state to tax wages earned in Connecticut.

As recognized in McBroom v. Department of Revenue, 14 OTR 239, 242 (Ore. 1997), "[a]n option granted as compensation for personal services is not a capital asset, and the exercise of such an option is not the sale of a capital asset." If the exercise was that of the sale of a capital asset that took place outside of the jurisdiction of Connecticut, then Connecticut, of course, would have no authority to tax that transaction taking place beyond its borders. As previously noted in Chase Manhattan Bank v. Gavin, 249 Conn. 184, it is a general principle that "a State may not tax value earned outside its borders."

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A capital asset has been defined in 26 U.S. Code § 1221 (a) to mean "property held by the taxpayer (whether or not connected with his trade or business), but does not include. . . (4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered. . . ."

(Internal quotation marks omitted.) In the present case, however, the value, as compensation, was earned in Connecticut.

Recognizing that § 12-711 (b) - 18 (a) of the regulations only pertains to the taxation of wages earned in Connecticut, the language of this regulation does not impinge on the plaintiffs' Due Process rights under the U.S. Constitution.

In the area of taxable income, it is a federal tax concept recognized in § 83 of IRC that where the nonqualified stock option has no market value, the stock option cannot be taxed as income until it has been exercised. This same concept must similarly be applied to nonqualified stock options granted to a Connecticut resident for services rendered in Connecticut but exercised at a time when the employee no longer was a resident of Connecticut.

The court agrees with the commissioner that Mr. Allen was required to report the exercise of the nonqualified stock options to the commissioner as part of his obligation to file a Connecticut income tax return for the taxable years of 2006 and 2007, reporting the earnings of Connecticut source wages.

Accordingly, for the reasons stated above, the commissioner's motion for summary judgment is granted and the plaintiffs' motion for summary judgment is denied. Judgment may enter in favor of the commissioner, without costs to any party.

Arnold W. Aronson
Judge Trial Referee