No. 16-1192

In The
Supreme Court of the United States

JEFFERSON ALLEN AND EVITA ALLEN,

Petitioners,

v.

COMMISSIONER OF REVENUE SERVICES OF THE STATE OF CONNECTICUT,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of The State Of Connecticut

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

While living in Connecticut, petitioner Jefferson Allen earned nonqualified stock options in Connecticut as compensation for services performed solely in Connecticut. These options did not have a "readily ascertainable value" at the time of the grant. Mr. Allen later exercised the options in three separate taxable years when he and petitioner Evita Allen were no longer Connecticut residents. The petitioners realized over $53 million in income from the exercise of these options. Connecticut taxes the income of nonresidents who have Connecticut taxable income "derived from or connected with" sources within Connecticut. This includes income recognized under section 83 of the Internal Revenue Code in connection with nonqualified stock options if such options were granted as compensation for services performed in Connecticut.

The question presented is:

Because the Due Process Clause of the Fourteenth Amendment requires a "minimal connection" between a taxing state and the person, property or transaction it seeks to tax, does Connecticut's taxation of a nonresident's income realized from the exercise of stock options satisfy due process when those stock options were earned in Connecticut as compensation for services performed solely within Connecticut?

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STATEMENT OF THE CASE

I. CONNECTICUT'S TAXATION OF NONQUALIFIED STOCK OPTIONS

Connecticut has an income tax. Conn. Gen. Stat. § 12-700. As part of its income tax framework, Connecticut taxes the income of nonresidents who have "Connecticut taxable income derived from or connected with sources within [Connecticut]," *id.* § 12-700(b), which phrase the respondent is statutorily required to define by regulation, *id.* § 12-701(c). Pursuant to this mandate, the respondent Commissioner of Revenue Services of the State of Connecticut has promulgated a regulation that addresses nonqualified stock options:

> Connecticut adjusted gross income derived from or connected with sources within [Connecticut] includes . . . income recognized under section 83 of the Internal Revenue Code in connection with a nonqualified stock option 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.

Conn. Agencies Regs. § 12-711(b)-18(a). This regulation permits a taxpayer to apportion such income if the optionee's services were not performed wholly within Connecticut. *Id.* § 12-711(b)-18(b), (c). It further provides that, after the optionee exercises an

option, the gain or loss resulting from a subsequent disposition of the stock "is not derived from or connected with sources within [Connecticut]." *Id.* § 12-711(b)-18(d).

II. FACTS

For eleven years, from 1990 to 2001, the petitioners resided in Connecticut. Pet. App. at 3. During that time period, petitioner Jefferson Allen served as president and chief financial officer of Tosco, Inc. Pet. App. at 3. As part of his compensation from Tosco, Mr. Allen was granted nonqualified stock options, which had no readily ascertainable value at the time of the grant. Pet. App. at 3. The services that Mr. Allen performed to earn these options were done solely within Connecticut. Pet. App. at 3. In 2002, while the petitioners were nonresidents of Connecticut, Mr. Allen exercised the options he had earned as compensation from Tosco, realizing $7,633,027 of income. Pet. App. at 3.

The petitioners returned to Connecticut in 2005, and from January 1, 2005 to August 31, 2005, Mr. Allen served as the chief executive officer of Premcor, Inc. Pet. App. at 3. As part of his compensation from Premcor, Mr. Allen was granted nonqualified stock options, which had no readily ascertainable value at the time of the grant. Pet. App. at 3, 65. The services that Mr. Allen performed to earn these options were done solely within Connecticut. Pet. App. at 3. In 2006, while the petitioners were nonresidents of

Connecticut, Mr. Allen exercised a portion of the options he had earned as compensation from Premcor, realizing $43,360,812 of income. Pet. App. at 4. Then in 2007, again while the petitioners were nonresidents of Connecticut, Mr. Allen exercised a portion of the options he had earned as compensation from Premcor, realizing $2,247,745 of income. Pet. App. at 4.

On March 8, 2007, the petitioners filed a Connecticut nonresident income tax return for the taxable year 2002, wherein they reported income from Connecticut sources in the amount of $15,946,626 and paid Connecticut income tax in the amount of $747,307. Pet. App. at 3, 55. On April 7, 2007, the petitioners filed a Connecticut nonresident income tax return for the taxable year 2006, wherein they reported income from Connecticut sources in the amount of $43,360,812 and paid Connecticut income tax in the amount of $2,167,637. Pet. App. at 4, 62. On April 11, 2008, the petitioners filed a Connecticut nonresident income tax return for the taxable year 2007, wherein they reported income from Connecticut sources in the amount of $2,247,745 and paid Connecticut income tax in the amount of $112,229. Pet. App. at 4, 69.

Then, on October 13, 2009, the petitioners filed amended Connecticut nonresident income tax returns for the taxable years 2002, 2006, and 2007, claiming refunds for the Connecticut income tax they had paid for those years. Pet. App. at 4. On October 12, 2012, the Audit Division of the Connecticut Department of Revenue Services denied the petitioners' claims for

refunds on the bases that the refund request for the taxable year 2002 had been filed beyond the applicable statute of limitations, and the income for the taxable years 2006 and 2007 had been properly reported in the petitioners' original tax returns as income from Connecticut sources. Pet. App. at 4, 56, 68 & 73. On November 20, 2012, the petitioners protested these determinations to the Appellate Division of the Connecticut Department of Revenue Services, which upheld the Audit Division's denials. Pet. App. at 4, 56, 68. On June 11, 2013, the respondent issued to the petitioners a final determination denying their claims for refunds. Pet. App. at 4, 57, 69, 74.

III. THE JUDICIAL PROCEEDINGS BELOW

The petitioners appealed the respondent's final determination to the Connecticut Superior Court. Pet. App. at 4. In ruling on the parties' cross motions for summary judgment on stipulated facts, the trial court held that (1) Connecticut's principles of sovereign immunity barred their claim for the taxable year 2002 because the petitioners' refund request had been filed beyond the applicable statute of limitations; and (2) Connecticut's taxation of the petitioners' income from the exercise of the stock options for the taxable years 2006 and 2007 did not violate due process because such income had a Connecticut source. Pet. App. at 4-5, 41-43, 46-52. The trial court accordingly entered judgment in favor of the respondent. Pet. App. at 4-5.

The petitioners appealed the trial court's decision, and the Connecticut Supreme Court transferred the appeal to itself. Pet. App. at 1. The Connecticut Supreme Court affirmed the decision of the trial court, analyzing both the sovereign immunity issue and the due process issue.[1]

First, the Connecticut Supreme Court held that because actions seeking tax refunds from the state were part of a statutory framework that waives Connecticut's sovereign immunity, and because Connecticut law requires such waivers to be narrowly construed and strictly confined to the extent provided by statute, sovereign immunity barred the petitioners' untimely claim for a refund for the taxable year 2002. Pet. App. at 5-13.

Second, for the taxable years 2006 and 2007, the Connecticut Supreme Court looked to federal law for guidance on the taxation of nonqualified stock options, as the Connecticut regulation incorporated the relevant portion of the Internal Revenue Code. Pet. App. at 15. The Connecticut Supreme Court noted that, under federal law, the transfer of property in exchange for the performance of services is generally subject to

[1] The Connecticut Supreme Court also analyzed an issue concerning the interpretation of the relevant Connecticut regulation. Pet. App. at 17-25. In this analysis, the Connecticut Supreme Court agreed with the respondent's interpretation that the regulation applied when an optionee was performing services within Connecticut at some point in the time period set forth in the regulation (*i.e.*, the first day of the taxable year when the option is granted to the last day of the taxable year when the option is exercised). Pet. App. at 17-25.

taxation; however, not all transfers are taxable events at the time of transfer. Pet. App. at 16. The Connecticut Supreme Court went on to note that one such transfer is the transfer of stock options with no readily ascertainable fair market value at the time of the grant. Pet. App. at 16. As the Connecticut Supreme Court stated, under federal law, taxation is merely deferred until the taxpayer exercises the option. Pet. App. at 16-17. The Connecticut Supreme Court also discussed how, under federal law, an employer's grant of stock options to an employee is compensation for services. Pet. App. at 32-33.

With these federal taxation principles in mind, the Connecticut Supreme Court went on to apply the due process standard this Court has set forth with respect to a state's taxation of a nonresident's income, namely, a "minimum connection" between the state and the person, property, or transaction it seeks to tax, as well as a "rational relationship" between the tax and the values connected with the taxing state. Pet. App. at 28-29. The Connecticut Supreme Court determined that Connecticut's taxation of the petitioners' income derived from the exercise of the stock options satisfied the "minimum connection" prong of this due process standard because Mr. Allen had earned the stock options as compensation for services performed solely in Connecticut. Pet. App. at 31-37. The Connecticut Supreme Court also determined that, because (as the petitioners had conceded) the "rational relationship" prong's principal application concerns cases involving a multistate business enterprise, and because Mr.

Allen was awarded the stock options for performing services only in Connecticut, this prong was inapplicable to the analysis here. Pet. App. at 37-38. Accordingly, the Connecticut Supreme Court concluded that Connecticut's taxation of the petitioners did not violate due process. Pet. App. at 38.

REASONS FOR DENYING THE WRIT

This Court should deny the petition because, contrary to the petitioners' claims, the Connecticut Supreme Court's decision does not conflict with the decisions of four United States courts of appeals, nor does it sow or widen any confusion about how to treat stock options that have no readily ascertainable value at the time they are granted. That is because there is no confusion about how to treat such stock options. As this Court noted over sixty years ago, "the uniform Treasury practice since 1923 has been to measure the compensation to employees given stock options subject to contingencies of this sort by the difference between the option price and the market value of the shares at the time the option is exercised." *C.I.R. v. Lo Bue*, 351 U.S. 243, 249 (1956). That is, an optionee's exercise of an option is the event whereby the compensation is actually measured and the tax imposed. The Connecticut Supreme Court, recognizing that Connecticut has incorporated the relevant federal law, conducted a deliberate and thorough analysis of the relevant federal principles and then applied them to this case. And the fact that Connecticut follows this

federal treatment is obvious: the respondent collected taxes for the years in which Mr. Allen exercised the options, not the years in which his employers awarded the options.

Indeed, it is the petitioners who are trying to sow confusion by mischaracterizing the Connecticut Supreme Court's decision and reframing the issue. The question before the Connecticut Supreme Court was not when such stock options are taxed, or what is the "taxable event," but whether, under the due process standard set forth by this Court, Connecticut may tax a nonresident on income realized from the exercise of stock options that were earned as compensation for services performed entirely in Connecticut. None of the four courts of appeals decisions presented by the petitioners addresses that question in any way. Moreover, the courts that have addressed this precise issue support the decision of the Connecticut Supreme Court. As such, this case does not present a situation where the Connecticut Supreme Court has "decided an important federal question in a way that conflicts with the decision of another state court of last resort or of a United States court of appeals," nor does it present a situation where the Connecticut Supreme Court "has decided an important question of federal law that has not been, but should be, settled by this Court, or has decided an important federal question in a way that conflicts with relevant decisions of this Court." Sup. Ct. Rule 10(b), (c). Therefore, the petition for a writ of certiorari should be denied.

I. THE PETITIONERS MISCHARACTERIZE THE DECISION OF THE CONNECTICUT SUPREME COURT, WHICH DOES NOT CONFLICT WITH DECISIONS OF THE FEDERAL COURTS OF APPEALS AND IS SUPPORTED BY DECISIONS FROM OTHER STATE COURTS

A. The Connecticut Supreme Court's Decision Does Not Conflict With The Decisions From The Federal Courts Of Appeals

The petitioners, in an effort to portray a conflict between the Connecticut Supreme Court's decision and certain decisions of the federal courts of appeals, mischaracterize the decision of the Connecticut Supreme Court. It is well-established that employee stock options are "compensation for personal service." *Lo Bue*, 351 U.S. at 247. And with respect to nonqualified employee stock options, the typical lack of transferability and other customary restrictions on their exercise make it so that, at the time of the grant, the amount of compensation that an employee receives is typically unknown, i.e., the stock options have no "readily ascertainable value." *See* 26 U.S.C. §§ 83, 422; 26 C.F.R. § 1.83-7. Therefore, for more than ninety years, it has been the uniform practice under federal law to measure the compensation to employees given such stock options by the difference between the option price and the market value of the shares at the time the options are exercised. *Lo Bue*, 351 U.S. at 249.

The courts of appeals decisions to which the petitioners cite simply stand for this principle, namely, that for employee stock options with no readily ascertainable value at the time of the grant, the compensation to the employee is typically measured not at the time of the grant, but at the time of the exercise, which is the taxable event. *See Pagel, Inc. v. C.I.R.*, 905 F.2d 1190, 1191 (8th Cir. 1990) ("[I]f an option does not have a readily ascertainable fair market value when granted, the recipient must recognize ordinary income at the time of exercise or disposal but not at the time of grant."); *Victorson v. C.I.R.*, 326 F.2d 264, 266 (2d Cir. 1964) ("Since the parties chose to make the taxpayers' right to the stock dependant [sic] on the payment of a sum of money, the Tax Court could quite properly consider the taxpayers' right an option. . . . We therefore conclude that the Tax Court did not err in holding that the income in question was realized on . . . the date the option was exercised."); *Van Dusen v. C.I.R.*, 166 F.2d 647, 650 (9th Cir. 1948) (rejecting the appellant's argument that the income realized from stock options earned as compensation was realized at the time the options were granted instead of at the times the stock was purchased); *see generally Robinson v. C.I.R.*, 805 F.2d 38, 40 (1st Cir. 1986) ("Section 83 of the Internal Revenue Code . . . states that the value of property transferred in connection with the performance of services shall be taxable income in the first taxable year in which 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 is applicable.") (emphasis in original; internal quotation marks omitted).[2] These decisions are fairly straightforward and uncontroversial, as they merely follow the principles established by this Court, *see Lo Bue*, 351 U.S. at 247-49; *C.I.R. v. Smith*, 324 U.S. 177, 179-82 (1945), and the provisions of the Internal Revenue Code, *see* 26 U.S.C. §§ 83, 422; 26 C.F.R. § 1.83-7. Indeed, these decisions are so unremarkable that the petitioners did not even cite to them in their briefs to the Connecticut Supreme Court.

The Connecticut Supreme Court's decision is similarly unremarkable in that it merely followed the federal treatment of these options. First, the Connecticut Supreme Court noted that, because the relevant state regulation incorporates the Internal Revenue Code, its decision would be guided by federal law on the treatment of nonqualified stock options. Pet. App. at 15. Second, the Connecticut Supreme Court recognized that, under federal law, "[n]ot all transfers of property in exchange for the performance of services are taxable events at the time of transfer," and that one such type of transfer is that of stock options without a readily ascertainable fair market value. Pet. App. at 16.

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[2] *Robinson* concerned the timing of paying tax on income realized from the exercise of options in a circumstance where, based on a sellback provision in the stock option agreement, the First Circuit found there to be both a substantial risk of forfeiture and a restriction on transferability of the stock at the time the option was exercised. *See Robinson*, 805 F.2d at 40-42 (holding that the timing of the tax was delayed until the sellback provision lapsed). Such a scenario is simply irrelevant to the issue presented in this case.

Third, the Connecticut Supreme Court explained that the uniform practice under federal law has been to measure the compensation to employees given such stock options by the difference between the option price and the market value at the time the options are exercised, which is the "taxable event." Pet. App. at 16-17. That Connecticut follows federal law by treating the exercise of such options as the taxable event is made obvious by the fact that the Connecticut Supreme Court upheld the respondent's imposition of the Connecticut income tax for the years in which Mr. Allen exercised his options, not the years in which he received them.

Therefore, the petitioners' assertion, that the Connecticut Supreme Court held the grant of the stock options to be the taxable event, is incorrect. There is no conflict between the Connecticut Supreme Court's decision and federal law.

B. The Connecticut Supreme Court's Decision Does Not Conflict With Any Decision From A State Court Of Last Resort, And Is Supported By State Court Authorities

Compounding the petitioners' mischaracterization is their failure to disclose to the Court that there are state court decisions involving circumstances similar to the one in this case that support the Connecticut Supreme Court's decision. The most relevant case is *Michaelsen v. New York State Tax Comm'n*, 496 N.E.2d

674 (N.Y. 1986), in which the New York Court of Appeals, following the federal treatment of stock options, held that New York could tax a Connecticut resident's income realized from the exercise of employee stock options for work done in New York because the income was sourced to (and thus taxable in) New York. *Id*. at 676-78; *see also Clapes v. Tax Appeals Tribunal*, 825 N.Y.S.2d 168 (N.Y. App. Div. 2006) (stock options granted to nonresident taxpayer for services performed in New York were properly taxed by New York, and the taxpayer's constitutional argument lacked merit), *appeal dismissed*, 868 N.E.2d 227 (N.Y. 2007) (dismissing appeal on the ground that it involved "no substantial constitutional question"). And other decisions concerning the same, or a substantially similar, issue likewise support the conclusion of the Connecticut Supreme Court. *See McBroom v. Dep't of Revenue*, 14 Or. Tax 239, 240 (1997) (when an option was granted for services rendered in Oregon by someone who was, at the time of the grant, a resident of Oregon, "any value derived from the option had its source in Oregon. Where [the taxpayer] was domiciled at the time of exercise is not relevant."), *aff'd*, 969 P.2d 380, 381 (Or. 1998) (rejecting the taxpayer's argument that "the gain that he realized upon the exercise of a stock option given to him by his employer was not taxable in Oregon, because he no longer was an Oregon resident at the time he exercised the option."); *see also Garcia v. Dep't of Revenue*, No. TC-MD 111074D, 2012 WL 1501258 (Or. T.C. Apr. 30, 2012) (same; following *McBroom*); *cf. Wardrop v. Middletown Income Tax Review Bd.*,

2008-Ohio-5298, 2008 WL 4541996 (Ohio Ct. App. Oct. 13, 2008) (Ohio city could tax income received from nonresident taxpayers' exercise of stock options because such options were granted as compensation for the taxpayers' employment services in the city, and the fact that the taxpayers neither resided nor worked in the town when they later exercised the options was immaterial). The Connecticut Supreme Court's decision is thus supported by the courts that have actually considered this issue.

II. THE CONNECTICUT SUPREME COURT'S DECISION IS CONSISTENT WITH THE DUE PROCESS STANDARDS SET FORTH BY THIS COURT

A. The Petitioners Mischaracterize The Primary Legal Issue Decided By The Connecticut Supreme Court

In an effort to reframe the case to their benefit, the petitioners misrepresent the issue the Connecticut Supreme Court addressed. The primary question presented was not when Connecticut could tax stock options, or what a "taxable event" is. And contrary to what the petitioners would have the Court believe, the Connecticut Supreme Court did not "dim" any bright line, "widen a conflict among the lower courts," or "sow confusion." That is because, as noted above, there is no conflict or confusion about how to treat such stock

options.[3] Connecticut, for its part, simply follows the federal treatment in that regard.

Instead, the question before the Connecticut Supreme Court was whether the Due Process Clause of the Fourteenth Amendment allows Connecticut to tax nonresidents on income realized from the exercise of stock options that were earned in Connecticut as compensation for services performed wholly within Connecticut. *See* Pet. App. at 2, 26-38. The standard established by this Court for answering that question looks to whether there is a "minimum connection" between the taxing state and the person, property, or transaction it seeks to tax, and a rational relationship between the tax and the values connected with the taxing state. *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16, 24 (2008); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-73 (1978). This is the standard that the Connecticut Supreme Court is required to apply, *see Chase Manhattan Bank*

[3] Indeed, it is the petitioners who have attempted to sow confusion by implying that the Connecticut courts do not understand the difference between compensation and realization of income, and by continuously arguing that employee stock options are essentially worthless when they are granted because they are "a gamble, not a guarantee." As discussed above, however, the Connecticut Supreme Court well understood the concepts of compensation and realization of income. Pet. App. at 33-37. And with respect to the alleged worthlessness of employee stock options, the fact that such options are often a sought-after component of executive compensation packages refutes the petitioners' argument.

v. Gavin, 249 Conn. 172, 184 (1999), and did, in fact, apply here, *see* Pet. App. at 28-38.

Given the actual constitutional question before the Connecticut Supreme Court, the irrelevancy of the four decisions on which petitioners rely—*Pagel*, *Robinson*, *Van Dusen*, and *Victorson*—is laid bare here. None of those decisions involved situations where a state attempted to tax the income of a nonresident. None of those decisions contained the terms "Fourteenth Amendment" or "due process"; in fact, none of them discussed any constitutional principles at all. And the irrelevancy of those decisions is underscored by the fact that the petitioners themselves did not cite to them in their submissions to the Connecticut Supreme Court.

B. The Connecticut Supreme Court Correctly Applied The Court's Due Process Standards To This Case

The stock options granted to Mr. Allen were compensation for services performed solely within Connecticut. Pet. App. at 3. Because the petitioners were not Connecticut residents when they realized income from Mr. Allen's exercise of these options, the Connecticut Supreme Court was required to apply the "minimum connection" due process standard established by this Court with respect to a state's taxation of a nonresident. *See MeadWestvaco Corp.*,

553 U.S. at 24.[4] This is what the Connecticut Supreme Court did. Pet. App. at 26-38. In doing so, the Connecticut Supreme Court correctly held that Connecticut's taxation of the petitioners' income satisfied the "minimum connection" standard because the income derived from stock options that Mr. Allen had earned as compensation for services performed in Connecticut. *See* Pet. App. at 31-32 ("The jurisdictional fact that Allen earned the stock options while performing services in Connecticut serves, for the purposes of the due process clause, as a sufficient 'minimum connection['] . . . . When [Mr.] Allen earned the stock options as compensation, he was performing services in the state of Connecticut. During the course of his service within the state, he enjoyed the benefits and protections attendant to employment within this state.") (footnote omitted).

Without the stock options earned as compensation in Connecticut for services performed in Connecticut, the petitioners would have realized none of the income in question. Therefore, Connecticut, and no other state, was the source of that income. This more than satisfies

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[4] The Connecticut Supreme Court noted that the second prong of the due process standard, *i.e.*, "a rational relationship between the tax and the values connected with the taxing state," principally applies in situations where a state seeks to tax some portion of the property or income of a multistate business enterprise, which application the petitioners conceded. Pet. App. at 37. Because it was undisputed that Mr. Allen earned the stock options for services performed only in Connecticut, and because the issue presented did not implicate a multistate enterprise, the Connecticut Supreme Court deemed this prong to be inapplicable to the constitutional analysis.

the "minimum connection" standard established by this Court, and the Connecticut Supreme Court was correct in holding due process permitted Connecticut to tax the petitioners' income. The petitioners thus present no good basis for this Court to review the decision of the Connecticut Supreme Court.

CONCLUSION

For all of the reasons set forth herein, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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