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“STATE TAXATION OF STOCK OPTIONS”

prepared by

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NEW YORK'S TAXATION OF STOCK OPTION INCOME: Recent Developments

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I. STOCK OPTIONS

A. Overview

1. Generally - Stock options exercised by residents are fully taxable by New York, even if the majority of the compensable period occurred while the taxpayer worked and lived elsewhere. *Belda* (ALJ May 4, 2006). But stock option income paid to a nonresident is taxable only if the options were received as compensation for work performed in New York State.
2. Federal Rules - For federal income tax purposes, an employee who receives a nonqualified stock option is generally not subject to federal income tax when the option is granted. The gain attributable to the difference between the option price (which will often be the stock's fair market value at the time of grant) and the fair market value of the stock upon exercise, however, will be treated as taxable compensation. When the stock is sold, any post-exercise appreciation is taxed as capital gain.
3. Stock Options Received by New York Residents - New York's rules follow these federal principles, and are easily applied to state residents, since the New York tax is based on federal taxable income.
4. Stock Options Received by Nonresidents - In *Matter of Michaelsen*, 67 N.Y.2d 579 (1986), the New York Court of Appeals confirmed that New York nonresidents who receive stock option income arising out of New York employment are subject to New York State personal income tax on the portion of the gain representing the difference between the option price and the fair market value of the stock at the time the option is exercised. Further, if at the time of the sale, the value of the stock has increased since the exercise of the stock option, the appreciation would be treated as investment income and would not be taxable to a nonresident.
5. TSB-M-95(3)I - In November 1995, the Tax Department issued TSB-M-95(3)I, which provided specific rules relating to a nonresident's allocation of stock option income where the nonresident performed services both inside and outside the state for his employer. The TSB-M states that stock option income should be allocated to New York based on the taxpayer's New York workdays during the period between the grant and the exercise of the option.

B. *Matter of Stuckless*, Tax App. Trib. (Aug. 17, 2006)

1. Core Holding - *Stuckless* held that stock option income received by a nonresident must generally be allocated to New York based on the taxpayer's work day factors during the year in which the option was exercised. This determination was based on the Tribunal's reading of 20 NYCRR §§ 132.18(a) and (b), which set forth the "default" rules applicable to employees performing services partly within New York. Regarding these provisions, the Tribunal stated: "[t]he rules and examples set out in section 132.18 of the regulations express, or strongly imply, an allocation based on work days within the taxable year in which the income is realized."
2. TSB-M-95(3)I Held Invalid - The Tribunal also held that TSB-95(3)I is invalid because the grant-to-exercise allocation methodology it requires is inconsistent with the regulations. The Tribunal held that the Department did not have the regulatory authority to impose a multi-year allocation method and that the TSB-M could not be enforced in place of a duly promulgated regulation because such enforcement would violate the State Administrative Procedure Act. In so holding, the Tribunal also determined that the TSB-M did not constitute a valid "alternative" allocation methodology under 20 NYCRR § 132.24.

C. New Regulations - The Department has adopted new regulations that require nonresidents who exercise stock options to allocate the option income to New York based on their work day factors between the date on which the options were granted and the date on which the options were vested. This grant-to-vesting method must be used for all tax years beginning on or after January 1, 2007. For the 2006 tax year, taxpayer have the option of allocating their options based on the grant-to-exercise method set forth in TSB-M-95(3)I.

D. Post-Termination and Post-Retirement Exercises - The Department has recently begun taking the position that it is not required to allocate a nonresident's stock option income based on the *Stuckless* year-of-exercise rule in cases where the taxpayer exercises options after retiring from or otherwise terminating employment with the employer who granted the options.

1. TSB-M-06(7)I - which was issued after the *Stuckless* decision, implies that use of the year-of-exercise rule may not result in a fair and equitable allocation of income in certain situations, such as when options are exercised post-termination or post-retirement. TSB-M-06(7)I suggests that it may be necessary in such cases to use an alternative allocation method, such as the multi-year grant-to-exercise approach previously set forth in TSB-M-95(3)I. The Department asserts that it has the authority to require an alternative method in such cases pursuant to 20 NYCRR § 132.24.

II. NONRESIDENT TAXATION OF STOCK OPTION INCOME ELSEWHERE

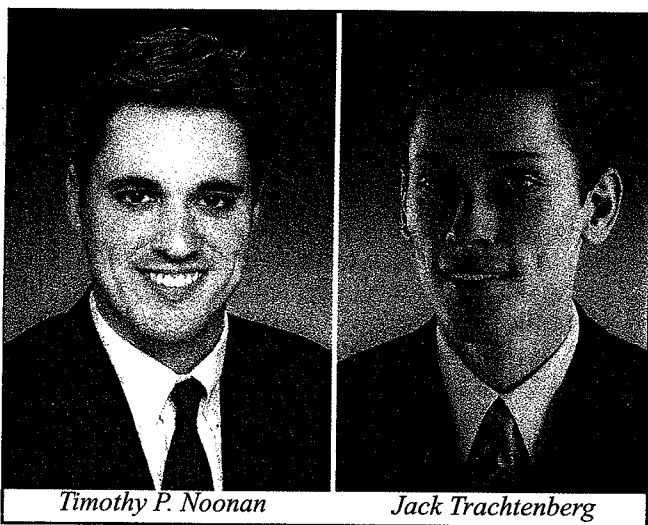
- A. **Generally** - The taxation of options varies from state to state. Here is a sampling of some of the different rules:

STATE	Taxation of Stock Options for Nonresidents
California	Taxed to the extent of California workdays from date of grant to date of exercise. FTB Tax News, May 2001.
Colorado	Taxed if employee worked in Colorado prior to exercising the options. Col. Tax Publication (Dec. 2001).
Connecticut	Regulations suggest that employee must work in Connecticut during year of grant AND year of exercise. Conn. Reg. 12-711(b)-18. Informal interpretation by Connecticut suggests they are taxed to the extent of Connecticut taxable compensation from Connecticut sources from date of grant to date of exercise.
Florida	Florida has no income tax, but its law exempts stock options granted to employees by their employers from its intangibles tax if the employees cannot transfer, sell or mortgage the options. Fla. Stat. § 199.185(m).
Georgia	No tax on a nonresident's exercise of options.
North Carolina	Taxed to the extent of North Carolina workdays during year of exercise.
Ohio	Ohio has specific rules for former residents who exercise options. Ohio tax is imposed on value of the options appreciation at the time the employee moved out of Ohio. Ohio Tax information Release 3/11/96.
Oregon	Income from the exercise of options taxable to a nonresident if any work in Oregon during the grant-to-exercise period. <i>See McBroom v. Oregon</i> , 969 P.2d 380 (1998). But Oregon has given no guidance on how to allocate for out-of-Oregon workdays.
Pennsylvania	Taxed to the extent of Pennsylvania workdays during year of exercise. <i>See Pennsylvania Office of Chief Counsel Letter Ruling PIT-00-068</i> (Oct. 31, 2000); <i>see also Marchelen v. Township of Lebanon</i> , 560 Pa. 453 (2000).
Wisconsin	Income from exercise of stock options allocable based on number of days worked in Wisconsin under the employment contract giving rise to the stock options. Wis. Dept. Rev. Release 103-3, 10/01/97.

- B. Other State Tax Credits** - These differing rules could create mismatches in resident credits given to resident taxpayers paying tax on stock option income in other states. For instance, Connecticut residents may be denied a full credit for taxes paid to New York because they take the position that option income is allocable based on an in-state compensation to out-of-state compensation ratio. New York's ratio is based on workdays alone.

Stock Options — The New York Tax Department's Effort To Undermine *Stuckless*

by Timothy P. Noonan and Jack Trachtenberg



Timothy P. Noonan

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Over the past couple years, *Stuckless* has been kicking around New York's Division of Tax Appeals and creating lots of uncertainty for tax practitioners and taxpayers in the stock option area. And unless you've been hiding under a rock for the past six months, you've probably also heard about the tribunal's momentous decision in *Matter of E. Randall Stuckless*¹ — in which it overturned its own previous decision.² That decision, a clear victory for taxpayers and practitioners who have been grappling with the Department of Taxation and Finance on the issue for the last decade, was supposed to end the debate on the stock option issue once and for all. Indeed, New York's long-standing policy of taxing a nonresident's stock option based on a multiyear "grant-to-exercise" workday allocation was disposed of in favor

¹Tax Appeals Tribunal (Aug. 17, 2006). (For the decision, see *Doc 2006-16137* or *2006 STT 167-15*.)

²Tax Appeals Tribunal (May 12, 2005). The tribunal's previous decision in *Stuckless* was reported on by the authors in a previous *State Tax Notes* article. For the article, see *State Tax Notes*, July 4, 2005, p. 95, *2005 STT 127-25*, or *Doc 2005-11908*.

of a simple and straightforward "year-of-exercise" rule. In short, under the tribunal's decision, a non-resident taxpayer pays New York tax only to the extent he or she worked in New York during the year the stock options were exercised.

Easy, right?

Much to the chagrin of taxpayers and their representatives, implementation of those new rules has been anything but easy. Instead, based on our recent experiences with auditors and discussions with tax department personnel, it appears that the department is, in fact, seeking to avoid the application of *Stuckless* in many situations, and in particular when options were exercised after a taxpayer had retired or otherwise terminated employment. In a technical bulletin (TSB-M-06(7)I) issued quickly after *Stuckless* was decided, the department seemed to assert that the year-of-exercise rule should not be used when options are exercised posttermination because it does not result in a "fair and equitable" allocation of income. That new TSB-M suggests it may be necessary in those cases to use an alternative allocation method, such as the same multiyear grant-to-exercise rule deemed invalid by the tribunal in *Stuckless*!

Rather than ending the debate, the department's response to *Stuckless* just creates a new issue to fight over.

So unfortunately, rather than ending the debate, the department's response to *Stuckless* just creates a new issue to fight over. But we think that is a fight taxpayers can win. In this article, we'll discuss this important decision in detail and address the department's recent attempts to limit its scope.

Background on *Stuckless*

E. Randall *Stuckless* was granted incentive stock options by his employer, Microsoft Corp., in 1991

