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Multistate Taxation of Stock Option Income -- Time for a National Solution?

by Timothy P. Noonan and Paul R. Comeau

In recent years, states have focused on the taxation of stock options and have developed income allocation and withholding rules for option income received by nonresidents. Those rules vary from state to state, and create a substantial risk that inconsistent state rules will lead to double or triple taxation without offsetting credits, especially because options have become a common method of compensating employees and executives in large and small companies alike. Concerns regarding Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," have arisen for many companies, whose officers are asked to certify compliance with confusing or inconsistent state tax rules.

In this climate, given the confusion and the differing rules in many states, some have suggested that it may be time to develop a multistate solution and a single, national approach for the uniform taxation of stock option income.[1] That could come from a cooperative multistate agreement or from federal legislation designed to remove that impediment to interstate commerce. This article reviews the stock option rules in New York and several other states and discusses the potential need for a common approach.

The New York Model

New York is a good place to start because its rules in the area of stock options are arguably the most developed -- and at the very least the most talked about -- in the entire nation. Indeed, over the past few years, following the New York Tax Appeals Tribunal's decision in *Matter of Stuckless*,[2] the treatment of stock option income earned by nonresidents has been one of the hot topics in New York tax circles. Keep in mind, of course, that the focus here is on the rules as they apply to nonresidents of taxing states. In almost all situations and in all states, the rules for residents are clear: Residents are taxed on all income, regardless of its source. The concern is that, as people are now working in many states outside their state of residence and compensation is often based in part on stock options, nonresidents (and their employers, who have withholding obligations) will be facing a quagmire on stock option issues.

As a starting point, most states, including New York, will look to federal rules, at least to determine the extent of the compensation. 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 on exercise, however, will be treated as taxable compensation. When the stock is sold, any postexercise appreciation is taxed as capital gain. In *Matter of Michaelsen*,[3] the New York Court of Appeals confirmed that New York nonresidents who receive stock option income from 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 when 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.

That case did not, however, address the question of how to allocate that income. Ten years after *Michaelsen*, the New York Department of Taxation and Finance issued TSB-M-95(3)I, a technical publication designed to publicize the department's position on the allocation of option income. And under TSB-M, stock option income was to 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. TSB-M continued to be the "rule" in New York for the next 10 years or so, although not without controversy. Taxpayers (at least one successfully)[4] challenged the department's application of TSB-M to their situation, and generally practitioners were concerned that the allocation rules were not spelled out in the law or in tax regulations, something the personal income tax law seemed to require.[5] That apparently also concerned New York's Tax Appeals Tribunal, which rejected TSB-M's grant-to-exercise approach in *Stuckless* and ruled that stock option income received by a nonresident must generally be allocated to New York based on the taxpayer's workday factors *during the year in which the option was exercised*.[6] In doing so, the tribunal held that the department did not have the regulatory authority to impose a multiyear allocation method and that TSB-M could not be enforced in place of a duly promulgated regulation because that enforcement would violate the State Administrative Procedure Act.

Following *Stuckless*, the tax department, at the behest of the State Legislature, promulgated new regulations.[7] Under the new regulations, nonresidents who exercise stock options are required to allocate the option income to New York based on their workday factors between the date on which the options were granted and the date on which the options were vested. That grant-to-vesting method must be used for all tax years beginning on or after January 1, 2007.[8]

Treatment in Other States

But that just describes the battle in one state. What about the others? A sampling of the rules in other states illustrates how murky an area this is.

Arizona. Options are taxable in Arizona when they relate to services performed in Arizona between date of grant and the date of exercise. Allocation is based on multiyear method, which is determined by applying a ratio (number of days worked in Arizona during the grant-to-exercise period versus number of days worked outside the state during the same period) to income derived from the exercise of the option.[9]

California. Options are taxed in California regardless of the employee's residency status at the time of exercise, and the allocation is based on a multiyear method, which is based on the number of days worked in California from date of grant to date of exercise.[10]

Colorado. Options are taxed in Colorado if the employee worked in Colorado before exercising the options, regardless of the employee's residency status at the time of exercise. Allocation is based on a multiyear method, which is based on the time worked in Colorado versus the time worked outside of Colorado.[11]

Connecticut. Connecticut regulations provide that stock option income is taxable if the employee performed services in Connecticut during the period beginning with the first day of the taxable year in which option was granted and ending with the last day of the taxable year in which the option was exercised (the period). Allocation of the income is based on a multiyear method, which is determined by applying a ratio (total in-state compensation received from the grantor during the period versus total overall compensation received from grantor during the period) to the excess of the fair market value of the stock over the exercise price.[12] Note that Connecticut uses year-by-year *compensation*, not year-by- year workdays, to determine the allocation.

Georgia. Georgia's rule is different from most states'. Under its rules, a nonresident is *not taxed* on the exercise of an option, regardless of whether the option was received while a resident.[13]

Idaho. Options in Idaho are taxable when the employee worked for the granting employer in Idaho during the period between the granting of the option and the date on which the option vested according to the contract granting the option. The allocation follows the grant-to-vesting approach and is determined by applying a ratio (number of days worked in Idaho for the granting employer versus total days worked between the date of grant and the date of vesting) to the compensation derived from exercising the option.[14]

Illinois. Illinois taxes options if they are attributable to services performed in Illinois, regardless of residency at the time of exercise. Allocation is based on workdays in the state versus workdays outside the state during the year options were earned or granted or, if that date is unclear, ratably over a five-year allocation period.[15]

Minnesota. Minnesota is another state that follows the Georgia approach. If income is recognized from the exercise of stock options in a year the taxpayer is not a Minnesota resident, that income is not taxable, regardless of whether the taxpayer was a Minnesota resident at the time of granting.[16]

North Carolina. Stock options attributable to services performed in North Carolina are taxable, regardless of the residency status of the taxpayer when the options are exercised. Allocation is based on a multiyear method, which is determined by applying a fraction (gross income from all North Carolina sources versus taxpayer's overall gross income) to the amount of income derived from the exercise of the option.[17]

Ohio. Ohio taxes options at the time of exercise if the stock option was received by the taxpayer for services performed in Ohio. The allocation method is unique, and is based on a "degree of appreciation" method. The taxable amount is determined by the appreciation of the underlying option that occurred while the taxpayer was an Ohio resident.[18]

Oregon. Income from the exercise of options is taxable if the nonresident did any work in Oregon during the grant-to-exercise period.[19] But Oregon has given no guidance on how to allocate for out-of-Oregon workdays.

Pennsylvania. Pennsylvania taxes an option when that the option was earned for services performed in Pennsylvania.[20] The income is allocated based on a multiyear method, which is determined by applying a ratio (the total number of days employed with the grantor) to the excess of fair market value of the stock over the exercise price.

Wisconsin. Options are taxed if the employee performed services in Wisconsin for the employer granting the option during the grant to exercise period. The allocation is based on a multiyear method, determined by applying a fraction (the number of days worked in Wisconsin under the employment contract granting the option compared with the total number of days worked everywhere under the contract) to the amount of income from the exercise of the option.[21]

A Multistate or Federal Solution?

As is obvious, there is much variety in the taxing methods. Some states allocate based on grant-to-vesting (New York and Idaho); some use New York's old grant-to-exercise approach (Arizona and California); some use the year-of-exercise method (North Carolina); others take different approaches (Connecticut, Illinois, Ohio, Pennsylvania, and Oregon); and a few won't tax the income at all (Georgia and Minnesota). Those differing rules could create mismatches, with resident credits given to taxpayers paying tax on stock option income in other states. For instance, North Carolina could claim full tax based on year of exercise, while New York would allocate based on the period from grant to vesting. New York would likely not allow a full credit for taxes paid to North Carolina under those circumstances. When sourcing rules differ, the amount taxed could exceed 100 percent of the income. Nonresidents could face double or even triple taxation in many states. That also creates problems for employers trying to figure out how to withhold personal income taxes on stock option income payable to transient employees and executives. Not only are rules different in various states, but the proper taxation of the income can involve the determination of workday locations going back 5, 10, or even 15 years!

Certainly all states are entitled to tax stock option income as they please. But at a certain point, questions arise from a tax policy standpoint as to how different those tests should be. States could cooperatively agree to allocate and withhold on options based on a uniform method, which has been done on other occasions. For instance, in 1996, North East State Tax Officials Association commissioners in 13 jurisdictions signed a historic cooperative agreement regarding domicile, statutory residence, and allocation. Only a portion of the agreement was implemented, because some states, including New York, never enacted required cooperative legislation. Nevertheless, the agreement was important. One of its "whereas" clauses is relevant to today's topic. It read as follows:

> WHEREAS, multiple taxation of identical income creates the appearance of unfairness and fosters increased non-compliance . . . NOW THEREFORE, the signatory states . . . agree . . . to create a more uniform approach in cases of multiple determinations of residency by member states.

The same approach could be applied to allocation of option income.

Federal intervention is also a possibility. It has been unsuccessfully tried before to correct the convenience rule dispute between New York and Connecticut, but on other occasions the federal government has stepped in to limit the states' abilities on important matters of state taxation. Public Law 86-272 is a good example in which Congress stepped in to curb the states' power to impose income taxes on out-of-state companies. More recently, Congress passed the State Taxation of Pension Income Act of 1995, which prohibited states from taxing the retirement income of individuals who are not residents of or domiciled in that state.[22] That limitation on states' ability to reach retirement income applied regardless of whether the retiree may have worked in the taxing state before retiring. Significantly, the act was not in the form of an amendment to the Internal Revenue Code, but rather codified under title 4, chapter 4 of the U.S. Code, which governs general matters between the states and federal government. Although the initial act applied only to employee pension and retirement plans listed in the Internal Revenue Code, Congress expanded the nonresident exemption in 2006 to cover some qualifying income received by retired partners as well.

Like pensions and retirement income, stock options are a form of deferred compensation. Therefore, a federal solution might be the most sensible approach. The actual method used is, of course, open to debate. The approach taken with pensions and retirement income would be the easiest to implement, providing for taxation only by the taxpayer's state of residence at the time of exercise. But other methods, such as a uniform allocation method, would also make sense and help to resolve the mess that exists in this area. In either case, federal intervention would bring certainty, which is often all that taxpayers and employers want. The way things look now, however, the only certainty is that you are likely to find a different set of rules, or at least a different way of applying them, in almost every state that imposes an income tax. Clearly, there has to be a better approach.

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Noonan's Notes on Tax Practice is a column by Timothy P. Noonan, a partner with Hodgson Russ LLP, Buffalo, N.Y. This week's column was coauthored by Paul R. Comeau, who also is a partner with Hodgson Russ LLP.

FOOTNOTES

[1] This month the topic is being discussed and presented at the New York State Bar Association's summer meeting in Bermuda.

[2] *Matter of Stuckless*, Tax Appeals Tribunal (Aug. 16, 2007). (For prior commentary on *Stuckless* by Timothy P Noonan and Jack Trachtenberg, see "Stock Options -- The New York Tax Department's Effort to Undermine *Stuckless*," *State Tax Notes*, Apr. 23, 2007, p. 279, *Doc 2007-9696* [**PDF**], or *2007 STT 79-7*; and "*Matter of E. Randall Stuckless and Jennifer Olsen*: New York Tax Appeals Tribunal Issues Stock- Option Decision," *State Tax Notes*, July 4, 2005, p. 95, *Doc 2005-11908* [**PDF**], or *2008 STT 127-25* <LNK:2008 STT 127-25>. For the Tax Appeals Tribunal's decision in *Stuckless*, see *Doc 2007-20081* [**PDF**] or *2007 STT 175-12*.)

[3] 67 N.Y.2d 579 (1986).

[4] That taxpayer was Lawrence Rawl, who prevailed in a 1998 administrative law judge hearing. *See Matter of Rawl*, ALJ (Dec. 10, 1998). Comeau represented the taxpayer in that case. (For the decision, see *Doc 98-37998* or *98 STN 250-7*.)

[5] *See* Tax Law section 631(b)(6).

[6] *Supra* note 2.

[7] *See* Tax Law section 631(g).

[8] *See* 20 NYCRR sections 132.24 and 132.25.

[9] Arizona Individual Income Tax Ruling No. 02-5, Oct. 21, 2002.

[10] FTB Publication 1004 (Mar. 2005).

[11] FYI Income 6: Part-Year Residents and Nonresidents (Colo. Dept. of Rev., December 2006).

[12] Conn. Reg. 12-711 (b)-18 (2007).

[13] Georgia Dept. of Revenue WebFaq, Individual Income Tax (2001).

[14] Idaho State Tax Commission Ruling No. 11786, Jan. 1, 1997.

[15] *See* Illinois Dep't of Revenue General Information Letter IT 03-0001-GIL, Jan. 6, 2003.

[16] Minnesota Revenue Notice No. 01-10, Oct. 15, 2001.

[17] *Secretary of Revenue of North Carolina v. Cella*, Docket No. 2004-200 (2004).

[18] Ohio Tax Information Release, Mar. 11, 1996.

[19] *See McBroom v. Dept. of Revenue*, 969 P.2d 380 (Ore., 1998).

[20] *See* Pa. Office of Chief Counsel Ltr. Rul. PIT-04-026, Sept. 24, 2004; *see also* Pa. Code 109.8.

[21] Wisconsin Department of Revenue Tax Pub. No. 122, Nov. 1, 2003.

[22] 4 U.S.C. section 114.

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