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Employee Stock Options and Separation Payments

By: Glenn Newman

Two recent decisions involving New York State tax on income from employee stock options and separation payments should be of great interest to many nonresidents who work in New York. Also, two cases involving combined returns under the State and City corporate taxes are noteworthy, one showing the pendulum may be swinging away from a series of taxpayer victories in the area and the other on the so-called "30-day Rule" which, until last year, required taxpayers to obtain permission to file a combined return. In addition, another State case is important for its discussion of an issue that has been around for many years but, until now, has had little written guidance.

Nonresident's Stock Options

Many corporations grant high-level employees stock options as part of their compensation packages. Although the Federal tax treatment of stock options is well-settled, (they are subject to tax when exercised), the treatment of such stock options is less clear under New York's Tax Law.

The case of *Matter of Lawrence G. Rawl*,(NYS Div. of Tax Appeals, December 7, 1998), involved stock options granted to the CEO of Exxon. These options were granted in the mid- 1980's at a time when Exxon's headquarters was located in New York and Mr. Rawl, a nonresident of New York, worked both inside and outside New York. In 1991, the year of exercise, Exxon had moved its headquarters to Texas and Mr. Rawl spent no time working in New York and, therefore, allocated no income from the exercise of the stock options to New York.

Over a period of time, the State had taken alternate inconsistent positions on the issue. Sometimes it taxed employee stock options based upon the time spent working in New York in year of exercise, and in other instances it taxed them based upon the time spent working in New York over the period of time between the date of grant and the date of exercise. This latter method would require taxpayers to track working days spent in New York as a proportion of total working days in each year from the date of grant to the date of exercise.

In a 1974 edition of a training manual, the State instructed auditors to allocate income from stock options based upon the allocation for the tax year in which the option was exercised unless conditions of employment were significantly different (i.e., retirement, change of office or employer, change of duties) or the taxpayer presented evidence that the allocation was not reasonable. A letter from the Technical Services Bureau of the Department issued to an unrelated taxpayer in 1987 used the year of exercise method for allocation as did at least six cases heard by the State Tax Commission in the 1970s and early 1980s.

Subsequent to litigation in 1986,[1] the State revised its thinking and drafted a regulation in 1990 setting forth the date of grant to date of exercise methodology as the proper method. The regulation was never adopted. Also, by early 1990 a draft Technical Services Bureau Memorandum setting forth the grant to exercise methodology was circulated within the Department and finally issued 1995.[2]

In the meantime, the audit of Mr. Rawl commenced and, in 1992, a memorandum from the Department's field audit management staff instructed the auditor to use the grant to exercise allocation method which was the basis for the Notice of Deficiency issued to Mr. Rawl on November 14, 1994.

The Administrative Law Judge canceled the Notice of Deficiency finding that the 1995 Technical Services Bureau Memorandum constituted a reversal of Department policy without prior public notice and therefore could not be applied retroactively to the 1991 tax year. The ALJ cited two cases[3] in which new policies were held not to be applicable to tax periods before their publication.

Nonresident's Termination Payments

A second ALJ case involved termination payments made to an executive after the company he worked for was acquired by another. In *Matter of Martin S. Davis*, (NYS Div of Tax Appeals, January 14, 1999), the taxpayer was the CEO of Paramount Communications, Inc. until it was acquired by Viacom in 1994. Under his contract, Mr. Davis' employment was to continue until 1997. He was also to receive payments until 1997 if his employment was terminated other than for cause, or if his contract was not assumed by a successor company.

Mr. Davis left Paramount's employ and received the payments called for under the contract. In his New York nonresident income tax return, he reported wages paid prior to his termination and income from stock options exercised allocated at 84.55%, which was the average ratio of wages allocated to New York over a period of 15 years. He excluded the termination payment. The State Tax Department asserted that the termination payment was a severance payment that constituted New York source income (at the 84.55% allocation, not calculated under the method called for under the TSB-M previously mentioned).

The ALJ stated the issue to be: "whether the payments petitioner received were in return for relinquishment of his future rights to employment or more in the nature of severance or guaranteed payments." The ALJ addressed the cases supporting each side's legal position. Payment for relinquishing a right to future employment is income from an intangible and is not New York source even if the current or expected employment was wholly within New York[4]. However, a severance payment where there is no right to future employment, no definite term of employment or employment at will, is payment for past services and therefore, is income attributable to a business or occupation carried on in New York and is New York source income[5].

After noting that the burden of proof was on the taxpayer to show that the payment was for relinquishing his right to future employment and was in consideration for a promise to work in the future, the ALJ held that Mr. Davis gave up his right to employment with Paramount for the period up to 1997. Therefore, the income was not New York source income and not subject to the nonresident income tax.

This case highlights the need for careful consideration of the State and local tax implications of employee separation agreements. In cases where the payment is for a compromise of disputed claims[6] or for a waiver of any claims arising out of or relating to past employment,[7] the income has been found to be New York source and subject to tax.

Combined Returns

In previous articles, we have discussed a series of taxpayer victories relating to the inclusion or exclusion of companies in a combined return.[8] Recently, the pendulum seems to be swinging the other way. The requirements for an affiliated company's being permitted or required to be included in a combined return have not changed. There are three tests: (1) that 80% of the stock be directly or indirectly owned or controlled; (2) that the companies be engaged in a unitary business and; (3) if reporting on a separate basis distorts the activities, income or capital in New York.[9] In the most recent case, *Matter of Tropicana Products, Sales, Inc.*, (NYS Div. of Tax Appeals, November 25, 1998), the State Tax Department successfully challenged an expert opinion on the arm's-length nature of intercompany transactions and showed distortion requiring the subsidiary's inclusion in the combined return. This is the second recent case[10] in which a taxpayer's expert testimony and analysis of intercompany transactions in support of separate returns was found insufficient to prevent the Department from forcing combination.

Tropicana

Tropicana involved three companies, Tropicana Products, Inc. ("Parent"), Tropicana Sales, Inc. ("Sales") and Progress Services, Inc. ("PSI"). The Parent, a Delaware corporation owns the "Tropicana" brand name and processes and packages the well-known juice products. It also engages in research and development of its products and provides administrative, personnel, accounting and tax, information systems and other corporate services to its affiliate. Sales is engaged in the wholesale sale and distribution of Parent's juice products. PSI is in the business of processing and selling waste orange peel for cattle feed and an industrial cleaner (called D'limonent). PSI operated exclusively in Florida and got its orange peel free of charge from its Parent. Prior to the commencement of PSI's operations, Parent disposed of its waste orange peels and incurred a cost to do so.

The State Tax Department sought to have all three companies file together on a combined basis. The taxpayers submitted a report prepared by a major accounting firm attempting to establish the arm's-length nature of the intercompany transactions in order to preclude combination

The ALJ, citing several Tribunal decisions,[11] applied principles of transfer pricing found in Internal Revenue Code Search7RH482 to the case at hand. The ALJ found the expert's report flawed. The ALJ pointed out the failure to identify businesses having the same functions as Sales (some of the companies used in the comparison were in the business of distribution but did not have Sales' transportation and marketing functions) and the fact that only 4 of 14 companies identified as comparable were located in the Northeastern U.S., the primary market of Sales. The ALJ also faulted the expert's reliance on two companies that distributed Tropicana products in the Baltimore-Washington D.C. market, noting that the geographic area served was not comparable to Sales' market area. Criticism was also directed at the use of unaudited financial statements and the fact that the expert did not use actual distribution costs. Also the ALJ found the expert's analysis of the pricing of transactions between PSI and Parent unconvincing. The ALJ held that the taxpayers had not sustained their burden of proof that the transactions were arm's-length and concluded that distortion required the filing of a combined return including all three companies.

The City Tax Tribunal's Administrative Law Judge Division issued a determination on the now discarded "30-day Rule".[12] *In Matters of Direct Pro, Inc. and Direct Worldwide, Inc.*, (NYC ALJ Div. February 23, 1999), the taxpayers won the battle but lost the war. In these cases (which were consolidated at the hearing) the taxpayers admitted that they had failed to request permission to file on a combined basis within 30 days of the end of their fiscal years but nevertheless filed combined returns with their parent company, N.W. Ayer & Son, Inc.

Stand-Alone Companies

After a desk audit of the returns, the City Tax Department 'de-combined' the two companies requiring them to compute their City general corporation tax as stand-alone companies solely on the basis of their failure to request permission. The taxpayers responded to the proposed adjustment by claiming they met the requirements for filing on a combined basis and maintained that claim at a conciliation conference protesting the Notice of Determination that had been issued. The City, argued that it was not required to review the substantive requirements of combination and relied upon a State Tax Tribunal case[13] holding that where a full field audit had not been done, the State's 30-day Rule applied. The City declined to examine the records offered by the taxpayers at the conciliation conference. The taxpayers replied that a later State Tribunal case[14] held that as long as there was a meaningful opportunity to audit the merits of combination, failure to comply with the 30-day Rule could not be used to preclude the filing of a combined return.

In the end, the ALJ decided that the City could not close its eyes, refuse to look at the merits of the combination issue and then claim it did not have a meaningful opportunity to audit. That was the good news for the taxpayer—the bad news was that they failed to prove that there was distortion resulting from the intercompany transactions and, on the merits, the ALJ held that separate returns were proper. While the City is unhappy with the result on the 30-day Rule, it may not appeal its victory on the merits. So, if the taxpayer does not take an exception, the case will be over, and since ALJ determinations are not precedent,[15] others may face the same issue.

Real Property

Both the State and City corporation taxes have as one of the alternative bases a tax on net capital allocated to New York. The laws require valuation of real property at fair market value and personal property (except marketable securities) at book value according to generally accepted accounting principles ("GAAP").

The group of taxpayers in *Matter of Arcade Broadway Plaza Rentals, Inc., et al* (NYS Div. of Tax Appeals, December 31, 1998), held interests in partnerships and limited partnerships that, in turn, held title to real property in New York and elsewhere either directly or through other partnerships. The taxpayers sought to have the partnership interests valued at book value in accordance with GAAP resulting in the group's State's corporate franchise tax being $500,000 less over a three-year period than if the fair market value of the real property itself was the measure of tax.

The Tax Department responded by claiming that the corporate tax generally follows conduit principles in its treatment of corporate partners. That is, for purposes of apportionment factors,[16] characterization of income and in arriving at net income or alternative minimum income subject to tax, the Federal principle that the partnership entity is disregarded applies. In other words, the partnership income and apportionment factors flow through the partnership and are treated as if held directly by the partner.[17]

The State ALJ held that partnership interests are personal property under New York law and the Legislature clearly intended for the valuation of personality to be different from the valuation of realty. He also stated that the regulations cited pertain to computing net income and alternative minimum income tax and allocation formulas but have no bearing on the capital base. The ALJ also rejected the Tax Department's argument based upon general principles of taxation since the statutory language on the distinction between personal and real property were clear and, presumably, the Legislature intended the distinction.

Future Appeals

In *Rawl*, *Tropicana* and *Arcade*, exceptions have been filed. Therefore, we can expect that the State Tax Appeals Tribunal will be heard on these matters.

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1 *Michaelsen v. New York State Tax Comm'n*, 67 NY2d 579. In *Michaelsen*, the Court of Appeals decided that a nonresident's income from stock options (the difference between the option price and the fair market value of the stock at the time of exercise) was compensation subject to New York tax rather than investment income that would not be New York source income and therefore not subject to tax on a nonresident.

2 TSB-M-95(3)I, issued November 21, 1995.

3 *Matter of Friesch-Groningsche Hypotheek Bank Realty Credit Corporation*, (NYS Tax Tribunal, December 28, 1990); *Howard Johnson Co. v. State Tax Comm'n.*, 65 NY2d 726 (1985).

4 *Matter of McSpadden*, (NYS Tax Tribunal, September 15, 1994); *Matter of Brophy*, (NYS Tax Tribunal, December 7, 1995). See also, *Donahue v. Chu*, 104 AD2d 523 (3rd Dept., 1984).

5 *Matter of Laurino*, (NYS Tax Tribunal, May 20, 1993); *Matter of Evans*, (NYS Tax Tribunal, June 4, 1998). See also, *Hoffmann v. Comm'r*, 228 AD2d 732 (3rd Dept., 1996).

6 *Matter of Evans*, *supra*.

7 *Hoffmann v. Comm'r.*, *supra*.

8 See, e.g., *Matter of U.S. Trust Corporation*,(NYS Tax Appeals Tribunal, April 11, 1996); *Matter of U.S. Trust Corporation*,(NYC Tax Appeals Tribunal, November 25, 1997); *Matter of New York Times Company*,(NYS Tax Appeals Tribunal, August 10, 1995).

9 Tax Law Search7RH211(4); 20 NYCRR Search7RH6-2.2. NYC Admin. Code Search7RH11-605.4; NYC Rules Sec. 11-91.

10 See, *Matter of Burnham Corporation*, (NYS Div. of Tax Appeals, July 10, 1997).

11 *Matter of Sears, Roebuck & Co.*, (NYS Tax Tribunal, April 28, 1994); *Matter of Campbell Sales Co.*, (NYS Tax Tribunal, December 2, 1993); *Matter of Medtronic, Inc.*, (NYS Tax Tribunal, September 23, 1993).

12 The "30-day Rule" for both the State and the City corporate taxes have been eliminated effective years ending on or after December 31, 1997. 20 NYCRR Search7RH6-2.4; NYC Rule Search7RH11-91(g).

13 *Matter of Chudy Paper Co.*, (NYS Tax Tribunal, April 19, 1990).

14 *Matter of Exhibitgroup, Inc.*, (NYS Tax Tribunal, October 19, 1995).

15 NYC Charter Search7RH168(d).

16 20 NYCRR 4-6.5, providing that a corporate partner must include its proportionate share of partnership property, payroll and receipts in computing its own business allocation percentage.

17 In furtherance of this position, the Department cited 20 NYCRR 3-13.2, providing that "[each item of income, capital, gain, loss or deduction has the same source or character in the hands of a partner for article 9-A purposes as it has in its hands for Federal income tax purposes. Where an item is not characterized for Federal income tax purposes, the source and character of the item shall be determined as if such item were realized directly from the source from which realized by the partnership."

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