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Stock Option Income – Double Taxed Income

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I. INTRODUCTION

Taxpayers who have been compensated with employee stock options, and their counsel, should pay mind to the risks of double taxation from the overlapping jurisdictional claims to their share of the gains derived from that compensation.[1] Some observers may predict this concern will diminish with declining Internet start-ups, which frequently paid employees in such options, and the faltering bull market, which triggered the exercise of such options. Nevertheless, as audits progress for tax returns for 1999, 2000, and 2001, clients and practitioners who dislike taxes, especially paying the same tax twice, need to be aware of the potential for issues to arise during these audits.

To conceptualize these issues, imagine a corporation grants 10,000 nonstatutory stock options to an employee on December 1, 2001. Assume, the corporation is based in State A and the employee resides in State B. On December 1, 2004, three years later, the employee retires from the corporation and moves to State C. While a resident of State C, the former employee exercises all 10,000 options. Unhappy with the retirement community in State C, the former employee relocates to State D on January 1, 2005 and sells the stock to a third party.

Analysis of potential jurisdictions that may tax the gain on the options requires considering State A, the state where the employee performed services; State B, the state the employee resided in when the corporation granted the stock option; State C, the state the employee resided in when the stock options were exercised; and State D, the state the employee resides when the stock is ultimately sold. Advanced planning and record keeping will be critical elements in mitigating, and hopefully eliminating these concerns. This Article serves as a first step for practitioners to become sensitized to the issues they may face and to provide guidance on how to avoid these issues.

Part II of this Article provides an overview of the different types of stock options provided to employees and the general federal and state and local rules concerning the taxation of such options. It is important to note that this Article limits its scope to the personal income tax consequences of stock options to employees, but employers are affected as well due to states' withholding tax rules. Employers may have to withhold employment taxes for multiple states and localities, which proves difficult because they may be unaware of the individuals change in residence after retirement or otherwise.

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[1] Double taxation for purposes of this Article means the income from the stock option is subject to tax in more than two states or local jurisdictions.

Part III of this Article highlights the pitfalls of employee stock options with two examples of how taxpayers may be affected by the dueling state and local tax regimes of New York and California, and then Illinois and Connecticut. This Article concludes with Part IV recommending how practitioners can avoid double taxation and how federal and state officials could remove the possibility altogether.

II. OVERVIEW OF FEDERAL AND STATE AND LOCAL TAX TREATMENT OF STOCK OPTIONS

A. *General Federal Rules*

In addition to the common practice of compensating employees with cash, an employer may also choose to compensate employees through the grant of restricted stock or stock options. Stock is generally considered "restricted" if the shares are nontransferable for a given period of time and if the stock is subject to a substantial risk of forfeiture. An employee stock option is the right granted by a corporation to an employee to purchase the corporation's stock at a specified price during a specified period. Generally, there are two types of compensatory stock options: statutory and non-statutory. Statutory stock options, non-statutory stock options and restricted stock are all techniques of compensation that defer taxation under the Internal Revenue Code and as such have rather strict rules regarding the timing and character of the income upon recognition.

1. *Statutory Stock Options*

There are two types of employee stock options the Internal Revenue Code provides favorable federal tax treatment: Incentive Stock Options (ISOs) and options granted under an employee Stock Purchase Plan (SPP).[2] Both types of options must be granted under a plan that meets certain qualification requirements set forth in Internal Revenue Code sections 422 and 423, respectively, which, among other things, generally restrict transfers of the options and the stock granted upon exercise and limit the amount of options exercisable in a given year.

For example, ISOs must be exercised within ten years of their grant date, at a price not less than the stock's fair market value at the time the option is granted, and they are restricted in how and when they may be transferred.[3] An employee does not recognize any income upon the grant or exercise of such options, and, provided they are held for the required holding period prior to exercise, the appreciation recognized on the subsequent sale of the stock is treated as capital gain.[4]

Stock granted under an employee stock purchase plan may be granted with an option price below the full market value of the stock as of the date granted; however, the discount may not exceed fifteen percent.[5] Similar to ISOs, an employee does not recognize gain upon the grant or exercise of the options.[6] Provided the options are held for the required holding period prior to

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[2] I.R.C. §§ 422-23.

[3] I.R.C. § 422(b).

[4] To qualify for capital gain treatment, ISOs must be held the later of two years from the date of option grant or one year from the date of exercise. I.R.C. § 422(a)(1).

[5] I.R.C. § 423(b)

[6] I.R.C. § 423(a)

exercise, only a portion of the proceeds recognized from the subsequent sale are included in income and the remainder of the proceeds is treated as capital gain.[7]

2. Nonstatutory Stock Options

Nonstatutory stock options or non-qualified stock options (NQSOs), are not subject to the transferability, discount, expiration date and other restrictions imposed on ISOs and SSPs.[8] As a result, NQSOs do not enjoy the same type of beneficial treatment that ISOs and SSPs receive. An employee that receives NQSOs is either taxed upon the grant of the options if the options have a readily ascertainable fair market value, or more commonly, are taxed upon the exercise of the options.[9] Upon exercise, the employee generally includes a specified amount in ordinary income; however, any appreciation recognized on subsequent sale of the stock is treated as capital gain.[10]

3. Restricted Stock

When an employee receives restricted stock as compensation, the value of the stock is not included in income until the stock either becomes transferable or fully vested.[11] Further appreciation after the date of vesting or the date when the stock becomes fully transferable will be taxed as capital gain upon the ultimate sale of the stock.[12] However, an employee can elect under Code section 83(b) to include the value of the stock in income upon grant and then all future appreciation will automatically be treated as capital gain.

B. *General State and Local Rules*

Jurisdictional issues often arise on the state and local tax level when there has been a change in resident status during the period between the employer granting the option and the employee exercising the option or selling the stock. Most states tax nonresidents on income derived from or connected with sources in their state, commonly referred to as a state's "source rules."[13] Returning to the hypothetical introduced in Part I, where the corporation is based in State A and the employee initially resides in State B, under State A's source rules, the employee may owe tax to State A on the income derived from the stock options because they are considered a form of compensation for services the employee performed in State A.[14]

Additional issues arise concerning how and when State A calculates the gain derived from the stock options. Most states have wage allocation rules, which dictate the timing and

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7 To qualify for capital gain treatment, an SPP must be held the later of two years from the date of option grant or one year from the date of exercise. I.R.C. § 423(a)(1).

8 I.R.C. § 83.

9 I.R.C. § 83(a).

10 I.R.C. §§1001, 1221 & 1222. Once the compensation element is closed under Code section 83, then the normal rules taxing sales of property under I.R.C. §§1001, 1221 and 1222 apply.

11 I.R.C. § 83(a).

12 I.R.C. §§1001, 1221 & 1222. Once the compensation element is closed under Code section 83, then the normal rules taxing sales of property under I.R.C. §§1001, 1221 and 1222 apply.

13 ARIZ. REV. Stat. § 43-1091 (2000); HAW. REV. STAT. § 235-4(b)(2000); MINN. STAT. § 290.014(2) (2000); N.J. REV. STAT. § 54A:2-1.1 (2001); S.C. CODE § 12-6-1720 (2001); WIS. STAT. § 71.02 (2000).

14 IND. Admin. CODE tit. 45. r. 3.1-1-7(stating "deferred compensation, other than that from a qualified retirement plan . . ., is directly attributable to services performed, and is taxed by the state where the services were performed" and "all income other than wages such as pension, annuity, profit sharing and stock option income is not covered by reciprocal agreements with other states."); cf. Ralston Purina Co. v. Leggett, 23 S.W.3d 697 (E.D. Mo. 2000)(ruling for St. Louis City Earnings Tax purposes that "stock options granted to employees as part of their compensation for services rendered are earned compensation").

amount of gain that should be allocated to the state.[15] Of course, state rules vary. Some state allocation approaches determine the amount of income subject to tax based upon an allocation beginning when the option is granted and ending when the option is exercised.[16] Yet, other states adopt an allocation based upon the year of exercise or upon the "employment contract period".[17] As discussed in Part III, New York State reversed its position during the past ten years. Because wage allocation rules typically require nonresident employees to track the number of days spent in a state working in order to determine the proper allocation percentage to apply to the total income from the stock options, the compensable period; either the date between the date of grant to the date of exercise or the year of exercise, becomes extremely important. This task is compounded when dealing with a corporate executive that travels around the United States or works in more than one office; multiple sourcing and tracking is necessary.

In addition, the latter compensable period allocation approaches (date of grant to date of exercise or year of exercise) also reflect a view that follows the federal treatment of employee nonstatutory stock options; an employee generally recognizes income upon the exercise of a nonstatutory option.[18] Thus, when the stock is sold to a third party, from a federal standpoint, another realization event occurs, resulting in taxable gain or loss. Should the state where the employee performs services, State A, also be able to reach the income earned during the period from the time of exercise to the time the stock is sold under its "source rules", or is the sale of the stock a separate realization event for state purposes to which the wage allocation rules do not apply? Part III discusses the distinction New York and Connecticut draw when examining this issue

The main tension with respect to state and local taxation of income from stock options, however, ensues as a result of states' general personal income tax schemes that tax all income from whatever source derived while a resident of the state.[19] In the hypothetical, State C, the state where the employee relocated to from State B and resided when exercising the stock options, could argue that all of the gain realized upon exercise is subject to State C's personal income tax since the employee exercised the options while a resident of its state.[20] As such, audits concerning stock options often involve determinations as to residence and domiciliary status, which are extremely invasive and often difficult to establish since the physical location of

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15 ARIZ. Admin. CODE R.15-2C-601 (2001); HAW. REV. STAT. § 235-34 (2000); MD. CODE ANN. TAXGEN. § 10-401 (2001); MD. REGS. CODE tit. 3, § 03.04.02.05 (2001); S.C. CODE ANN. § 12-6-2220 (2000).

16 *See, e.g.*, CONN. AGENCIES REGS. § 12-711(b)-18 (2000).

17 Tax Comm'n State of Idaho, Docket No. 11786, June 1, 1998 (adopting Minnesota's "employment contract period" approach over New York State's date of grant to date of exercise approach when determining the proper allocation of stock option income to Idaho); Minn. Dep't Revenue, Revenue Notice No. 96-21 (1996), Individual Income Tax - Assignability of Income Recognized on Employer Provided Stock Options (stating "[i]n the case where a non-resident individual recognizes income when the option is granted or when the option is exercised, the Minnesota source income is the income recognized for federal purposes multiplied by the ratio of days worked in Minnesota during the employment contract period granting the option over the total of days worked under the contract.")

18 *See supra* Part II.A. (discussing the federal tax treatment of nonstatutory stock options).

19 ARIZ. Rev. STAT. § 43-1011 (2001); HAW. REV. STAT. § 235-4(a) (2000); MINN. STAT. § 290.014(1) (2000); WIS. STAT. § 71.02 (2000).

20 *See* Pa. Dep't of Revenue, No. PIT-00-080 (stating income from stock options from whatever source must be reported on a Pennsylvania income tax return of a Pennsylvania resident). *See also infra* Part III(discussing the same treatment in New York, California, Illinois, and Connecticut).

a person must be proved on a day-to-day basis in certain states.[21] Individuals, in particular high-level employees that receive stock options as part of their compensation packages and own property in many states, are often deemed a resident of multiple states for the same tax period. All of these jurisdictions usually claim the right to tax the stock option income.

As in most other areas of state and local taxation, states rely on a credit mechanism to prevent double taxation. However, Part III illustrates that the credit mechanism fails in certain areas and instances resulting in an individual paying tax to multiple jurisdictions on the same income. The United States Constitution demands that a state must have a certain connection or nexus to the individual or transaction it seeks to tax. Resident status is sufficient,[22] as is physical presence, the performance of certain services in the state, and ownership of property in a state.[23] Thus, from a constitutional nexus standpoint multiple taxation of stock option income appears constitutionally sound.[24] From a policy standpoint, however, one must posit whether a change in residence should result in the imposition of more taxes. A federal solution was necessary in the area of pension income to avoid double taxation.[25] There was great sympathy in Congress for retirees and aggressive pursuit of pensioners who moved to states with no income tax or low rates.[26] Such a fix for stock option income, although desirable, is unlikely because there may not be such sympathy for higher paid employees who received stock options.[27]

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[21] *See, e.g.*, Minn. R. §8001.0300 (stating "[i]n counting the number of days spent within and without Minnesota, a person shall be treated as present in Minnesota on any day if the person is physically present in Minnesota at any time during that day");*see also Matter of Alfano*, DTA No. 817356, 2001 N.Y. Tax LEXIS 91, at *3 (N.Y. Div. of Tax App. April 12, 2001)(demonstrating the intrusiveness of residency audits); Matter of Brush, DTA No. 817204, 2000 N.Y. Tax LEXIS 92, at *2 (N.Y. Div. of Tax App. April 12, 2001) (to same effect); *Matter of Tamagni*, 91 N.Y.2d 530 (1998) (illustrating the difficulty of demonstrating a day spent outside the state).

[22] Cohn v. Graves, 300 U.S. 308 (1937); Lawrence v. State Tax Comm'n, 286 U.S. 276 (1932).

[23] Shaffer v. Carter, 252 U.S. 37 (1920). Indeed, the House Judiciary Committee Report accompanying legislation eliminating multiple state taxation on pension income, cited a portion of the United States Supreme Court's *Shaffer* opinion, when examining the constitutionality of a source based theory of taxation in the United States, which is as follows:

> We deem it clear, upon principle as well as authority that just as a State may impose general income taxes upon its own citizens and residents whose persons are subject to its control, it may, as a necessary consequence, levy a duty of like character, and not more onerous in effect, upon incomes accruing to nonresidents from their property or business within the State, or their occupations carried on therein. H.R. 104-389, 104th Cong., (1995).

[24] One could argue that the multiple incidence of taxation violates the Commerce Clause, as it constitutes an undue burden on individuals engaging in interstate commerce. This type of successful Commerce Clause challenge may prove difficult to obtain. However, Congress relied upon its power to regulate Commerce among the states when it enacted Public-Law 104-95,which restricts state taxation of pension income. A strong argument can be made that the same authority and reasoning applies with respect to stock option income. Below is an excerpt of the reasoning by the House Judiciary Committee:

> The activity that is being regulated under H.R. 394 is the economic relationship between a State and its former resident. The transactions are both within the stream of interstate commerce. Both the person who has retired and the pension payments have crossed State lines.

[25] State Taxation of Pension Income, Pub. L. No. 104-95, 109 Stat. 979 (1996).

[26] *See generally*, H.R. 104-389, 104th Cong., (1995).

[27] *Id.*(stating that "[d]espite the legal and conceptual bases for pension source taxes, the burden imposed on retirees, especially those with relatively low incomes, are all too often simply unreasonable").

III. DOUBLE TAXATION

A. *New York and California*

Double taxation may occur when an individual performs services in New York City for a multistate corporation and is granted NQSOs as compensation for the individual's New York City services, if there is a subsequent relocation of the employee from the New York office to the California office. Certain property and non-business ties to New York remain, and the employee exercises the NQSOs shortly after the move to California. This fact pattern will be referred to as "Example 1."

New York State, like most states, taxes residents on all income regardless of source and part year residents on all income regardless of source received while a resident of the state.[28] Conversely, nonresident individuals are taxable on income derived from New York sources.[29] In the case of nonresident employees working partly in New York and partly outside the state, the tax statute provides that the items of income derived from New York sources are determined by "allocation and apportionment under the [Tax Department's] regulations."[30] Although the regulations provide that the portion of an employee's wages derived in New York is determined by comparing the number of working days in New York to the total number of working days, the regulations do not provide any guidance with respect to stock option income.[31] In contrast, the regulations contain specific guidance on the allocation of income resulting from other deferred compensation, such as pension payments and termination pay.[32] There has been an attempt to clarify New York State's tax treatment of stock options received by nonresidents and part-year residents, in the form of a New York State Department of Taxation and Finance, Technical Services Bureau, Memorandum, TSB-M-95(3)I (the "Memorandum").[33] Still, many question the validity of this Memorandum as providing the type of rules that the tax statute requires to be set forth by regulation.[34] The Memorandum also clearly states that the rules contained therein represent a reversal of the State's policy.[35]

Juxtaposed with the New York State personal income tax rules are the New York City personal income tax rules. A resident of New York City is required to pay tax to the City of New York on all items of income regardless of its source and part-year residents are required to pay income tax on all income accrued while a resident of New York City, including income from stock options received for performance of services for a New York City business.[36] Although the

[28] N.Y. TAX LAW § 601(a) (McKinney 2001) (imposing tax on residents); N.Y. COMP. CODES R. & REGS. tit. , §118.1 (2001)(defining the N.Y. taxable income of a resident); N.Y. TAX LAW § 601(e) (McKinney 2001) (imposing tax on part-year residents).

[29] N.Y. Tax LAW § 601(e) (2001).

[30] N.Y. Tax LAW § 631(c) (2001).

[31] N.Y. Comp. CODES R. & REGS. tit. 20, §132.18 (2001).

[32] N.Y. COMP. CODES R. & REGS. tit. 20, §132.20 (2001).

[33] N.Y. Dep’t of Tax’n & Fin., Technical Services Bureau, *New York Tax Treatment of Stock Options, Restricted Stock and Stock Appreciation Rights Received by Nonresidents and Part-Year Residents*, TSB-M-95(3)I, (Nov. 21, 1995) [hereinafter Memorandum].

[34] *See, e.g.,* Paul R. Comeau & Andrew B. Sabol, *Latest Version Of* New York's Nonresident Allocation Audit Guide Still Leaves *Questions Unanswered,* 9 J. Multistate Tax'n (WGL) 22, Mar./Apr. 1999; *see also infra* note 41 (providing a more detailed explanation of the Memorandum and technical issues related to such Memorandum).

[35] Memorandum, supra note 35.

[36] N.Y.C. Admin. CODE, tit. 11, ch. 17, §11-1701 (2001).

New York City nonresident earnings tax, which imposed a tax on an employee's wages earned inside New York City,[37] was repealed as of July 1, 1999, for the period before its repeal it increased the chances of double taxation since the nonresident and part-year resident stock option allocation rules in effect for state purposes applied for City purposes as well.[38] As a result of the repeal, if the individual is not considered a resident of New York City at the time of exercise, then none of the income associated with the exercise of the stock options is taxable by New York City.[39] Thus, New York City and New York State would likely argue that the individual in Example 1 never changed residency to California. A brief review of New York's residency rules becomes necessary.[40]

A person is a resident of New York if domiciled in New York or if the individual maintains a permanent place of abode in the state and spends at least 183 days in New York.[41] Domicile is a question of intent – the place that the person intends to be a permanent home, is considered the place of domicile.[42] Once established, a domicile continues until the person moves to another location with the intent to make the new location a permanent home.[43] The New York State Department of Taxation and Finance generally considers the following factors in determining whether a change in domicile has occurred: (1) the person's use and maintenance of a New York residence; (2) the person's pattern of employment; (3) where the person spends most time during the year; (4) where the person holds items "near and dear" to his or her heart; and (5) family, business and social interests in the state.[44] Issues arise when an employee relocates to another state, in particular, if the employee's family relocates at a later date (e.g., the children remain in school for another month), the employee has not yet sold his New York home, or the employee retains New York contacts. The employee in Example 1 would have to demonstrate by "clear and convincing evidence" that there was a change in domicile to California to avoid taxation on all taxable income-federal adjusted gross income with certain New York addbacks and subtractions.[45] Alternatively, the employee would have to defend against a finding of statutory residence if the employee retained a home in the state. New York would require the employee to prove that he was not physically present in the state for at least 183 days.[46] If the employee cannot establish that days or any part of days spent in New York total less than 183 days, then all of the income related to the stock options would be subject to tax.[47] Even if the employee is deemed a nonresident or part-year resident of New York, New York will argue that the stock option income is taxable as New York source income.

Two related questions after residence status is determined concern whether New York considers the exercise of an option to be a separate realization event from the ultimate sale of the stock and what New York considers to be the tax base subject to tax upon the realization

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37 A similar earnings tax continues to apply in Yonkers.

38 Memorandum, supra note 35.

39 N.Y.C. ADMIN. code, tit. 11, ch. 17, §11-1701 (imposing New York City Personal Income Tax solely on "every city resident individual, estate, and trust").

40 With respect to tests for domiciliary status, New York City piggybacks New York State's personal income tax provisions.

41 N.Y. TAX LAW § 605(b)(B)(McKinney 1999).

42 See generally N.Y. Dep't of Tax'n & Fin., INCOME TAX – DIST. OFF. MANUAL, Nonresident Audits, 10-32, May 9, 1994 [hereinafter Audit Manual]; N.Y. COMP. CODES R. & REGS. tit. 20, § 105.20(d) (2001).

43 Audit Manual, supra note 44, at 10-32; N.Y. COMP. CODES R. & REGS. tit. 20, § 105.20(d) (2001).

44 Audit Manual, supra note 44, at 11-23.

45 *Bodfish v. Gallman*, 50 A.D.2d 457, 458 (N.Y. App. Div. 1976).

46 N.Y. Tax LAW § 605 (b) (McKinney 1999).

47 N.Y. Tax LAW § 605 (b).

event(s). In *Michaelson v. Commissioner*,[48] the Court of Appeals rejected the nonresident taxpayer's claim that stock option income-gain incurred over the period from the date of grant of the options to the date of exercise of the options is investment income.[49] Specifically, it held that there are two distinct realization events where an employee exercises stock options and then sells the stock associated with the options.[50] Thus, the Court of Appeals determined that only income from the first event, the exercise of the stock options, is taxable as compensation. Whereas, gain realized from an increase in the market value of the stock between the time the employee exercised the options and sold the stock is "clearly investment income rather than compensation."[51] Therefore, this gain cannot be attributable to the employee's occupation in New York and cannot be taxed by the state, because nonresidents are not taxed on intangible income earned in the state.[52] Thus, *Michaelson* resolved the issue relating to the total compensation that can be includable in a nonresident's New York source income.[53]

However, the *Michaelson* decision failed to address the proper methodology for allocating stock option income.[54] Historically, New York taxed the income from the exercise of stock options based on the nonresident employee's allocation to New York during the year the options were exercised.[55] Thus, New York taxed all of the value of the gain realized upon exercise where an employee performed all of his services in New York during the year of such exercise.[56] In other words, New York utilized a year of exercise methodology, whereby the employee had to apply an allocation formula consisting of a numerator representing total workdays in New York during the year of exercise and a denominator consisting of total number of workdays during the year of exercise, to the total value of gain realized upon exercise.

In November 1995, the State released the Memorandum discussed briefly above. This Memorandum reasons that "since the court determined that compensation constitutes the appreciation in the value of the stock between the option grants and exercise dates, that period is considered the period over which the employee's performance of service will be measured (compensable period)."[57] Further, the State citing Regulation Sections 132.4(c) and 132.18, states:

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48 67 N.Y.2d 579 (1986).

49 *Id.* at 585.

50 *Id.* at 583.

51 *Id*. at 589.

52 *See* N.Y. COMP. CODES R. & REGS. tit. 20, § 132.5 (2001). Income from intangible property (gains from the sale of stock) is New York source income only to the extent that it is from property employed in a business, trade, profession or occupation carried on in the state.

53 Matter of Rawl, DTA. No. 813892, 1998 N.Y. Tax LEXIS 402, at *42-44, (N.Y. Div. of Tax App. Dec. 10, 1998) ; see also Memorandum, supra note 35 (providing the Department's position that "Michaelson resolved the issue concerning the total compensation that may be includable in the New York source income of a nonresident . . ."); *Cf.* Conn. Agencies Regs. §12-711(b)-18 (2001) (stating "[t]he difference between the amount realized on the disposition of the stock and the fair market value of the stock, at the time such option was exercised, is gain or loss that is not derived from or connected with sources within this state").

54 Matter of Rawl, 1998 N.Y. Tax LEXIS 402, at *43 (Dec. 10, 1998); see also Memorandum, supra note 35 (stating that the Court of Appeals in *Michaelson* did not address how the stock option income received by a nonresident should be allocated for New York purposes).

55 Matter of Christiansen, N.Y. Tax Comm'n (Aug. 26, 1977); *Matter of Rawl*, 1998 N.Y. Tax LEXIS 402, at *43 (Dec. 10, 1998).

56 Id.

57 Memorandum, supra note 35.

> It is the Tax Department's position that any allocation must be based on the allocation applicable to regular (non-option) compensation received by the employee during the compensable period. The allocation is computed by multiplying the compensation attributable to the option by a fraction whose numerator is the total number of working days worked by the employee inside New York during the compensable period, and whose denominator is the total days worked by the employee both inside and outside the state during the compensable period. However, if an employee exercises an option after terminating employment with the employer who granted the option, the compensable period, and therefore the allocation, is limited to the days worked inside and outside the state during the period from the date of grant to the date employment ceases.[58]

Thus, New York reversed its position and adopted a date of grant to date of exercise allocation methodology, or date of grant to the date of employment ceases allocation methodology. The latter approach opens another Pandora's box for tax practitioners with respect to determining the date employment ceases. Today many corporate executives receive complex termination agreements where the date that physical performance of services ceases does not always coincide with the date that employment ceases for other purposes.

In *Matter of Rawl,*[59] the Chairman and Chief Executive Officer of Exxon Corporation, Lawrence G. Rawl argued that the memorandum was invalid insofar as it attempts to change the law without amending the corresponding personal income tax regulations. In this case, Exxon Corporation relocated its corporate headquarters from New York City to Texas.[60] The headquarters were based in New York until August 23, 1990.[61] During this same time period, Rawl resided in Connecticut and commuted to work in New York and throughout the world on behalf of the corporation.[62] Rawl and his family relocated to Texas upon the relocation of the corporate headquarters.[63] In 1991, Rawl exercised options, generating $9,567,725 in income, none of which Rawl allocated to New York due to the absence of any New York working days during the year of exercise.[64]

New York challenged Rawl's allocation, applying an allocation formula with a spread from the date of grant to the date of exercise.[65] As a result of document production in preparation of trial, it became clear that the Department had been re-examining its treatment of stock option income for nonresidents.[66] Specifically, a draft of the Memorandum released in 1995 was prepared as early as 1990.[67] Internal department memoranda also discuss the validity of issuing a memorandum as opposed to amending the personal income tax regulations.[68] The Administrative

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58 *Id*.

59 DTA. No. 813892, 1998 N.Y. Tax LEXIS 402, at *1 (N.Y. Div. of Tax App. Dec. 10, 1998). *Matter of Rawl* is an Administrative Law Judge decision. It is important to note that Administrative Law Judge determinations are not precedential.

60 *Id.* at *5-6.

61 *Id.* at *6.

62 *Id.* at *7.

63 *Id.*

64 Matter *of Rawl,* DTA. No. 813892, 1998 N.Y. Tax LEXIS 402, at *8 (N.Y. Div. of Tax App. Dec. 10, 1998).

65 *Id.* at *11-12.

66 *Id.* at *36-37.

67 *Id.*

68 *Id.* at *36.

Law Judge of the New York State Tax Appeals Tribunal ruled that the Memorandum, which was issued while the Rawl audit and litigation continued, could not be retroactively applied to Rawl.[69] Although this represented a win for Rawl, the decision left unclear the question of the application of the Memorandum to employees that exercise stock options after the publication of the memorandum that were granted prior to that date.

Returning to Example 1, if the employee is considered a nonresident or part-year resident, New York will claim a date of grant to date of exercise allocation methodology and will consider only the income realized from the date of grant to the date of exercise as New York source income. If the employee is considered a resident of New York, all the income associated with the exercise of the stock option would be subject to tax, and if still deemed a resident at the time of sale of the stock, then all income associated with the sale of the stock would be subject to tax. However, a resident of New York is allowed a credit for taxes paid to other states "upon income both derived therefrom" and subject to tax under Article 22 of New York's Personal Income Tax.[70] Yet, the credit cannot reduce the amount of tax otherwise due if the income subject to tax by the other state were excluded from the person's New York income.[71] Thus, New York would allow a credit for any taxes paid to California on the stock option income if the employee is considered a resident of both states.[72]

Under California law, a resident is defined as: (1) every individual who is in the state (physical presence) for other than a temporary or transitory purpose, and (2) every individual domiciled in California who is outside the state for a temporary or transitory purpose.[73] Factors that indicate California residency include: (1) ownership of real property in the state, particularly location of principal residence, (2) sending children to California schools; (3) obtaining a California drivers license (4) permanence of work assignments in California, and (5) family, social, and business interests in the state.[74] A presumption of residency occurs if a person spends more than nine months in the state.[75] Once deemed a resident, such individual must pay tax on all income from whatever source derived.[76]

California recently amended its Personal Income Tax law for determining the tax owed by individuals that are part-year residents or non-residents.[77] The primary purpose of the amendments was to clarify the manner in which loss carryovers, deferred deductions, and deferred income are to be calculated in computing a part-year or nonresident's California income

69 Matter *of* Rawl, DTA. No. 813892, 1998 N.Y. Tax LEXIS 402, at *83 (N.Y. Div. of Tax App. Dec. 10, 1998).

70 N.Y. TAX LAW § 620(b) (1999).

71 N.Y. TAX LAW § 620(a).

72 N.Y. TAX LAW § 620(a).

73 CAL. REV. & TAX. CODE § 17014(a) (West 2001).

74 State of Cal., Franchise Tax Board, Guidelines For Determining Resident Status - 2001, FTB Publication No. 1031 [hereinafter *Residency Guidelines*] (determining residency on the strength of an individual's ties to California, as opposed to the number of ties to the state); Matter of Peskin, 61 SBE 39, 1961 Cal. Tax Lexis 46, at *11 (Cal. St. Bd. of Equalization. Jul. 18, 1961) (ruling that an Illinois resident's visits to California prior to his move to the state, had only a transitory purpose until he abandoned his Chicago apartment and moved his household goods and personal effects to California); *cf. Residency Guidelines*, at 2 (ex. 2) (determining the exact date of California residency as the time when the individual came to California on an indefinite job assignment, even though such individual did not sell its home and transfer its bank account to the state until two years later).

75 Cal. REV. & TAX. Code §17016 (West 2001 & Supp.).

76 Cal. REV. & TAX. Code § 17041(a) (West 2001 & Supp.).

77 Ch. 920 (AB 1115) Laws 2001 (effective and applicable to taxable years beginning on or after Jan. 1, 2002).

tax liability.[78] However, the general theory underlying the taxation of part-year residents remains the same: persons moving into or out of California are required to pay tax on all income "regardless of source" while a resident of the state and pay tax on income from California sources while a nonresident.[79] California's regulations continue to provide that wages and salaries have a source where the services are performed.[80] Thus, California source income is generally limited to compensation for personal services performed within California.

When a person changes its status from a California nonresident to resident, former Section 17544 of the California Revenue and Taxation Code, which was the law until January 1, 2002, provided:

> There shall be included in determining income from sources within or without this state, as the case may be, income and deductions accrued prior to the change of status even though not otherwise includable in respect of the period prior to that change, but the taxation or deduction of items accrued prior to the change of status shall not be affected by the change.[81]

Thus, under the prior law when an employee became a California resident, items accrued prior to the change were not taxed by California unless they constituted California source income. Acknowledging that California law was "silent on the tax treatment of loss carryovers, deferred deductions, and deferred income that vested prior to the time individuals became part-year or non-California residents", the legislature repealed Section 17544 cited above and amended Section 17041 to state "for the purposes of computing 'taxable income of a nonresident or part-year resident' under paragraph (1), any carryover items, deferred income, suspended losses, or suspended deductions shall only be includible or allowable to the extent that the carryover item, deferred income, suspended loss, or suspended deduction was derived from sources within this state."[82]

With respect to stock option income, the recent amendments produce the same result as under prior law because they address "deferred income that vested prior to the time individuals became part-year or non-California residents."[83] In *Matter of Barnett*,[84] the California State Board of Equalization ruled that a Canadian resident who moved to California with an option to buy 4,800 shares, which was exercised in California when the person was living in California, was taxable there.[85] This was because the income did not accrue until the exercise of the option.[86] The Board based its decision on the fact that the right to receive income and the amount of income to be received became fixed and determinable only upon the exercise of the option.[87]

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[78] Id.

[79] CAL. REV. & TAX. Code §17041(i)(1)(B) (West 2001 & Supp.).

[80] Cal. CODE REGS. tit. 18, §§ 17951-2, 17951-5 (2001).

[81] Cal. REV. & TAX. Code § 17544 (West 2001 & Supp.).

[82] Cal. REV. & TAX. Code § 17041(i)(3) (West 2001 & Supp.).

[83] Ch. 920 (AB 1115) Laws 2001 (citing Legislative Counsel's Digest); see also Cal. Franchise Tax Bd, Stock Option Guidelines, FTB Publication 1004 (2002) [hereinafter FTB Stock Option Publication].

[84] 80 SBE 122, 1980 Cal. Tax Lexis 40 (Cal. St. Bd. of Equalization. Oct. 28, 1980).

[85] *Id.* at *9.

[86] *Id.* at *8-9.

[87] Under California's rules, as under the Code, if a NQSO has a readily ascertainable fair market value at the time they are granted, the options are subject to tax when granted. If the NQSOs are without a readily ascertainable fair market value when granted (including, among other things, it is excercisable immediately in full by the optionee and is not subject to any forfeiture restrictions), as in most instances, then they are subject to tax when exercised. Accordingly, in limited instances the result may differ from the result reached in *Barnett*.

Accordingly, in Example 1, California would likely claim that the employee was a resident of the state prior to the date of exercise, and thus, when exercised, all of the income associated with the stock options would be subject to California Personal Income Tax.[88]

The next significant question becomes, if the stock options are taxable in California upon exercise and taxable in New York, as either New York source income or income from whatever source derived, what type of credit, if any, would the employee be entitled to claim for taxes paid to New York. In general, California residents and part-year residents are allowed a credit against their California "net tax" for net income taxes paid to another state on the same item of income that was taxed in California.[89] "Only doubly taxed income qualifies for the tax credit in view of the clear and unequivocal language of Section 18001 [of California's Revenue and Taxation Code]."[90]

In addition, California source rules apply. The credit is only allowed for "taxes imposed by and paid to another state on income from personal services performed within such state."[91] Expressly disallowed is any credit for "taxes paid to another state on income from sources without such state even though such income may be taxable by such state, either because the taxpayer is domiciled therein or is considered a resident of such state notwithstanding that he is also considered a resident of this State."[92] Under these rules, a credit is disallowed if the jurisdiction allows the California resident a credit for the taxes paid to California on the same income.[93] Additionally, no credit is allowed for taxes paid to any local government, such as a city or county.[94]

In light of the above rules, if New York considers the employee in Example 1 a resident of New York, then California may disallow the credit in its entirety. If, however, the employee is solely considered a resident of California and the stock option income is allocable one hundred percent to work performed in New York, California would credit the entire New York State tax on such income, but not the New York City tax.[95] California may also argue that a portion of the stock options relate to services performed in California and reduce the credit.

Another set of rules that must be kept in mind is the statutes of limitations for assessment for personal income tax in New York and California. California has a four-year statute of

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88 See FTB Stock Option Publication, supra note 86, at 2 (citing *Barnett* and stating "if you are granted a nonstatutory stock option while a nonresident of California and later exercise the option while a California resident, the difference between the fair market value of the shares on the exercise date and the option price is taxable by California because you are a resident of this state when the income is recognized").

89 Cal. REV. & TAX. CODE §18001(a) (West 2001).

90 *Matter of Littrell*, 71 SBE 8, 1971 Cal. Tax LEXIS 47, at *3 (Cal. St. Bd. of Equalization. Mar. 22, 1971) (ruling that a California resident is not entitled to a credit for taxes paid to New York unless the income on which the tax is based is also subject to tax in the same year by California).

91 Cal. Form 540 NR, Sched. S, 2001, Other State Tax Credit, Instructions, 2 (stating "[r]esidents of California may claim a credit for net income taxes imposed by and paid to another state only on income which has a source within the other state"). Further, the Instructions provide "[f]or this purpose, California's sourcing principles apply even though the results may be contrary to the other States' principles." *Id.*

92 Cal. CODE REGS. tit. 18, § 18001-2 (2001).

93 Cal. REV. & TAX. CODE § 18001(a)(2) (West 2001 & Supp.).

94 Cal. CODE REGS. tit. 18, § 18001-1 (2001); Cal. Form 540 NR, Sched. S, 2001, Other State Tax Credit, Instructions.

95 See FTB Stock Option Publication, supra note 86, at 2 (determining that an individual that was granted a nonstatutory stock option while a resident of Michigan, which is a California resident when the nonstatutory stock option income is recognized, is entitled to a credit against California taxes if the individual paid tax to Michigan on this double-taxed income).

limitations for assessment, after the return was filed.[96] New York's period of assessment runs for three years from the date the return was filed.[97] As a result of the shorter New York statute of limitations, it may be prudent to file as a New York resident for the year of exercise, because if deemed a California resident on audit after the expiration of the New York statute of limitations, the employee would be able to receive a credit for taxes paid to New York on the same income.

B. *Illinois and Connecticut*

Consider Example 2: double taxation may occur when an individual performs services in Connecticut, is granted NQSOs as compensation for services, and later relocates to the state of Illinois where the corporation he performed services for in Connecticut has its base of operations. The employee shortly thereafter exercises the NQSOs he received while a Connecticut resident. Assume that the employee as a manager of the corporation spends one week each month assisting in the management of the Connecticut office.

Illinois imposes a tax on "net income" on every individual on the privilege of earning income or receiving income in the state or as a resident of the state.[98] Net income is the portion of the taxpayer's base income for the taxable year that is allocable or apportionable to Illinois less certain deductions.[99] Section 203(a) of the Illinois Income Tax Act provides that an individual's base income is an amount equal to the individual's federal adjusted gross income subject to certain additions and subtractions.[100] Further, Section 301(a) provides that "all items of income or deduction which were taken into account in the computation of base income for the taxable year by a resident shall be allocated to this state." Illinois' resident and domicile rules are similar to California's rules, detailed above.[101] Thus, in Example 2, the employee will have a difficult time maintaining the position that the move to Illinois is for "temporary or transitory purposes" and would be considered a resident taxable upon his entire net income.[102] As such, pursuant to Section 301(a) of the Illinois Income Tax Act, to the extent any gain upon the exercise of the NQSOs is included in federal adjusted gross that income is one hundred percent taxable by Illinois.[103]

Private Letter Ruling No. IT-94-0035, issued by the Illinois Department of Revenue, supports this position and states:

> [T]o the extent that the value of stock options are included in the federal adjusted gross income (AGI) of an Illinois resident in the year of exercise, that income is allocable to Illinois for State income tax purposes even if the right to those stock options may be partly attributable to years in which the taxpayer was nonresident.[104]

The Ruling continues to provide that the resident may be entitled to a credit for any foreign tax paid on the same income, if such stock option income is subject to tax in another state.[105]

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[96] Cal. REV. & TAX. CODE §17024.5(g) (West 2001 & Supp.).
[97] N.Y. TAX LAW § 683(a) (2001).
[98] 35 Ill. COMP. STAT. 5/201(a) (2001).
[99] ILL. ADMIN. CODE tit. 86, § 100.2050(a) (2001).
[100] ILL. COMP. STAT. 5/203(a) (2001).
[101] *See* generally ILL. ADMIN. CODE tit. 86, § 100.3020 (2001)(defining resident for Illinois income tax purposes).
[102] See ILL. ADMIN. CODE tit. 86, §100.3020(c) (2001).
[103] ILL. COMP. STAT. 5/301(a) (2001).
[104] P.L.R. IT-94-0035 (Ill. Apr. 18, 1994) (citing the Illinois Income Tax Act provisions quoted above).
[105] *Id*.

However, Section 601(b)(3), the authority relied upon in the Ruling, states that "[f]or purposes of this subsection, no compensation received by a resident which qualifies as compensation paid in this State as determined under Section 304(a)(2)(B) shall be considered income subject to tax by another state or states."[106] Further, section 304(a)(2)(B) provides that compensation will be considered "compensation paid in this State" if the person's service is performed entirely within Illinois; the person's service is performed both within and without Illinois, but the service performed without is incidental to the person's service performed within Illinois; or some of the service is performed within Illinois and either the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is within Illinois, or the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the person's residence is Illinois.[107] Under this definition, the employees performance of services in Illinois, and the fact that the corporate headquarters is located in Illinois, preclude a credit for the employee on any taxes paid to another state on this stock option income, by virtue of the fact that it is considered compensation paid in Illinois. In other words, because the exercise occurred in Illinois, while the employee performed services in Illinois, the income is considered earned in Illinois at the time of exercise.

Double taxation may occur if Connecticut considers the income from the stock option income as Connecticut source income and does not provide a credit to the now nonresident employee. Under Connecticut law, it appears that the stock option income would be Connecticut source income on the basis that the employee continues to perform services in Connecticut based upon his management of the Connecticut office. As set forth in detail in Connecticut Regulation Section 12-711(b)-1, Connecticut adjusted gross income of a nonresident derived from or connected with sources within Connecticut is the portion of Connecticut adjusted gross income derived from or connected with Connecticut sources.[108] Compensation paid to a nonresident employee rendering personal services as an employee, whose presence in Connecticut for employment purposes is "casual, isolated and inconsequential, is not considered to be derived from or connected with sources" within Connecticut.[109] However, an example in Connecticut Regulation Section 12-711(b)-4, provides that a regional manager of a shoe manufacturer that has an office in the company's corporate headquarters in Rhode Island, but spends one week each month assisting in the management of the company's three Connecticut stores, will be considered to be performing personal services as an employee in Connecticut.[110] Thus, the employee in Example 2 may be considered to be performing services in Connecticut.

The double taxation may occur as a result of Connecticut Regulation Section 12-711(b)-18, which provides the state's rules for dealing with the income from nonqualified stock options.[111] Specifically, the Regulation provides that Connecticut adjusted gross income derived from or connected with sources in 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

[106] ILL. COMP. STAT. 5/601(b)(3) (2001).
[107] ILL. COMP. STAT. 5/304(a)(2)(B) (2001).
[108] Conn. AGENCIES REGS. § 12-711(b)-1 (2001).
[109] Conn. AGENCIES REGS. § 12-711(b)-4(c)(2) (2001).
[110] Conn. AGENCIES REGS. § 12-711(b)-4 ex. 7.
[111] Conn. AGENCIES REGS. § 12-711(b)-18.

option was exercised . . . the optionee was performing services within Connecticut.[112]

Together with Regulation Section 12-711(b)-4, which supports a finding of performance of services within the state at the time of exercise, Regulation Section 12-711(b)-18 would consider the stock option income Connecticut source income at the time exercise. Due to the fact that Connecticut does not provide nonresidents a credit for taxes paid to other states, the employee may owe tax to both Illinois and Connecticut.

IV. RECOMMENDATIONS

One ideal solution would be federal legislation mandating that the state of residence (domicile) at the time the options become subject to tax provide a credit for taxes paid to any other state or locality for taxes paid to such state or locality on the stock option income, without regard to the state or locality of residence's wage allocation source rules. Of course any provisions enacted would have to provide a mechanism to disallow the credit if taken in the other jurisdiction so that tax is paid at least once. Alternatively, Congress could extend Public Law 104-95, which precludes states from taxing the pension income of nonresidents, to stock options.[113] Until Public Law 104-95 passed, some of the states discussed in this Article aggressively attempted to tax nonresident retirees that moved to other locations in the United States.[114] Indeed, the House Judiciary Committee Report, House Report No. 104-389, submitted with the federal state taxation of pension income legislation, states "California, has aggressively sought to tax annuity payments made to retirees who have moved elsewhere."[115] With the Internet start-up company craze subsiding and the decline of the strong bull market over the last few months, income from stock options may be less of an issue in the short term. Nevertheless, the issues discussed herein will arise more frequently over the next couple of years as taxpayers' tax returns for tax years 1999, 2000, and less so for 2001, are under audit. One of the key arguments asserted by proponents of Public Law 104-95, which applies equally in the case of stock options, if not more, is the tremendous amount of record keeping that is necessary under the current regime.[116]

For example, it is absurd for former residents of New York, ten years after their employment in New York has ceased to have documentation to prove their physical presence or lack of presence in New York from the period between the date of grant of their options to the date of exercise. This is a particular problem for options granted before the 1995 Memorandum was issued or for residents of New York who did not need to keep that information for filing tax returns when at the time they lived in New York there was no need to gather and retain such information because they were taxed on their entire net income.

If federal legislation is unobtainable, then a multi-state effort could alleviate the risk of double taxation. Double taxation as a result of dual residence is a problem that has been around for years.[117] Some states have entered into general reciprocal tax agreements to avoid double

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112 Conn. AGENCIES REGS. §12-711(b)-18(a) (2001).

113 Pub. L. No. 104-94, 109 Stat. 979 (1995).

114 H.R. REP. NO. 104-389 (1995).

115 *Id.*

116 *Id.*, at 6 (discussing the "complexities of record-keeping necessitated by source taxation.").

117 *See, e.g.*, Assn. of the Bar of the City of N.Y., *Individual Double Taxation in the Tri-State Region*, *reprinted in* 4 State Tax Notes (TA) 856 (Apr. 12, 1993).

taxation when an individual is considered a resident of two states.[118] These agreements generally preclude nonresidents from being taxed in the source state. In fact, one of the most widely known cooperative effort to eliminate double taxation occurred with respect to professional athletes.[119] A joint effort on behalf of all of the states to eradicate double taxation with respect to stock option income is welcomed.

Until some legislative mending takes place, an employee should try to exercise options prior to a move to another state. Although this sounds nice on paper, practically it may not be possible. If this is the case, as it often is, or if the options have already been exercised, then it would be prudent to review the relevant states' statute of limitations on assessment and filing of claims for refund or credit for taxes paid to another state. If the individual believes that he may be found to be a statutory resident of another state he may consider filing a protective refund claim in the other state in which he resides to preserve any credit that may be available. The employee should retain records that demonstrate working days spent inside and outside the state at issue. Unfortunately, unlike a pure residency audit where a sample year may be applied when multiple years are at issue, it is unclear whether such a sample allocation would pass muster in determining the spread for stock option income.

V. CONCLUSION

This Article provides two examples of the type of double taxation that may occur as a result of multiple jurisdictions claiming a right to stock option income. The result reached in Example 1, is at best, more alarming from a tax policy standpoint than the result reached in Example 2, because the State of New York could tax a person on income earned solely by contact that may have occurred ten or fifteen years ago. Example 2 at least taxes an individual that would be required to file a nonresident return on the basis of its present interaction with the state. New York's rules are indeed largely inconsistent with other states' rules that provide a credit to alleviate any double taxation. However, New York is not the one bad apple, as illustrated by the multiple taxation that occurred with respect to pension income, which was a result of the same rules that create problems in the stock option income area.

As noted above, this Article limited its scope to the personal income tax consequences of stock options to the employee without discussing the employer impact. Employers should review their withholding policies to ensure that they are satisfying their duties under multiple jurisdiction circumstances.

[118] See, *e.g.*, MINN. STAT. § 290.081(b) (2001)(providing an agreement between Minnesota and Wisconsin).

[119] *See generally* Federation of Tax Administrators, *State Income Taxation of Nonresident Professional Team Athletes: A Uniform Approach*, 6 State Tax Notes (TA) 1215 (May 9, 1994).