R&H Letter to Clients and Friends *September 28, 2006*

Recent Developments in State Taxation Affecting Nonresidents: *Payments to Retired Partners and Stock Option Income*

There have been several recent developments regarding the state income taxation of deferred compensation that are worthy of note. These developments may affect the preparation of tax returns for 2005 that have not yet been filed, may warrant amending tax returns already filed for 2005 and prior years, and may also present planning opportunities for 2006 and thereafter. If you have income of the type affected by these new developments it may be advisable to confer promptly with your tax advisor.

Retroactive Exemption of Retirement Income of Nonresident Partners

In 1996 Congress enacted a federal statute (the Pension Source Act, or the "Act") that prohibited states from imposing income tax on the retirement income (as defined) of nonresidents.

The Act defines "retirement income" to include payments from qualified plans (such as 401(k) and pension plans), annuities, IRAs, deferred compensation plans of state and local governments and tax-exempt organizations, and benefits from "nonqualified deferred compensation plans" as defined for purposes of the FICA (social security) tax imposed with respect to employment. In the case of nonqualified plans, the payments must generally be made for life or a life expectancy period, or for a period of not less than ten years, and the payments generally must be made in "substantially equal periodic payments."

New York took the position that the Act did not prohibit a state from imposing its income tax on payments received by retired partners under nonqualified deferred compensation plans, because such payments did not meet the federal statute's definition of "retirement income." Other states collected income tax from nonresident retired partners on similar grounds.

In August, 2006, Congress responded to the states' efforts to tax nonresident retired partners by amending the Act retroactively to clarify that payments to retired partners from nonqualified deferred compensation plans could qualify as protected retirement income. To so qualify, payments to retired partners made from a nonqualified deferred compensation plan (or other deferred compensation program or arrangement) must:

- provide for retirement payments based on prior service;
- be made pursuant to a plan in effect prior to the date of the partner's retirement; and

- meet certain other requirements specified in the Act.

The 2006 amendments also clarified the Act's requirement that payments from a nonqualified deferred compensation plan (other than so-called "excess benefit" plans) be made in "substantially equal periodic payments." The Act had not previously specified what types of arrangements would (or would not) meet this requirement, and at least one state had taken the position that payments could not qualify if a pre-determined formula was used to cap the total amount of payments. The Act as amended still does not provide a comprehensive definition of this requirement. It does, however, clarify that using a pre-determined formula to cap the total amount of payments, or making cost of living or similar adjustments to the prescribed payments, will not violate the "substantially equal periodic payment" requirement.

Significantly, the 2006 amendments apply to payments received *after December 31, 1995*. Any nonresident partner who has previously reported partnership retirement income as subject to tax by a state in which the partner is not a resident should consider discussing with his or her tax advisor whether a refund claim is appropriate.

Stock Options, Stock Appreciation Rights and Restricted Stock: What is the New York Portion of a Nonresident's Compensation Income?

Until recently, New York's income allocation rules for deferred compensation from stock options and the like seemed to be fairly settled. However, a variety of recent developments, described below, have produced new rules for 2007 and beyond, a choice of rules for 2006, and uncertainty for 2005 and earlier tax years.

As a general rule, individuals who work in New York but reside elsewhere must pay tax to New York State on the portion of their compensation that is attributable to services performed in New York. The same rule applies when a nonresident (or part-year resident) recognizes income from the grant, vesting or exercise of stock options, stock appreciation rights, or restricted stock (herein "Stock Option Income"): compensation that is attributable to services performed in New York is subject to New York State income tax.

Unlike an annual salary, however, Stock Option Income often represents compensation for services provided over multiple years, and in multiple locations. Moreover, Stock Option Income may be recognized in a tax year in which an individual's work patterns, and even residence, differ from the prior years to which the compensation relates. As a result, there has been much uncertainty in New York as to how a nonresident individual's Stock Option Income should be allocated between New York and other states in which the individual performed services. This uncertainty has been magnified by a recent decision of the New York State Tax Appeals Tribunal.

To begin almost at the beginning, in 1986, New York's highest court ruled that even though Stock Option Income may, in form, be recognized when a taxpayer disposes of the underlying instrument, sells an intangible, to the extent it in fact reflects compensation, New York can tax nonresidents on the portion of the income that is allocable to New York services.[1] That decision did not, however, explain how the allocation should be made.

Seeking to address many of the questions that soon arose, in 1995 the New York State Department of Taxation and Finance issued a Technical Services Bureau Memorandum (the "TSB").[2] It stated that Stock Option Income is allocated to New York based on the number of days worked by the employee in New York from (i) the date of grant to (ii) the date of exercise, as compared to the total workdays in that period. In the case of restricted stock, compensation generally was allocated under the TSB based on the employee's New York workdays from (i) the date of acquisition of the restricted stock to (ii) the date of vesting, again as compared to total workdays.

A taxpayer named Stuckless challenged this regime. His particular facts were that he had zero New York workdays in the periods when Stock Option Income was recognized for federal income tax purposes. He therefore argued that, under the existing regulations, New York could not tax any portion of that income.

The New York Tax Appeals Tribunal first ruled, in May of 2005,[3] that Mr. Stuckless should apply something like a mark-to-market approach, and essentially pay tax on the value of his Stock Option Income at the time he moved out of New York. Citing the novelty of this interpretation, the Department petitioned for reargument. In August of this year the Tribunal withdrew its first decision and issued a new one,[4] albeit not the one the Department wanted.

In its new opinion the Tribunal agreed that, based on the existing regulations, a nonresident who did not work *at all* in New York during the tax year in which Stock Option Income was recognized could not be taxed by New York *on any part* of that income. Moreover, the Tribunal expressly declined to follow the TSB, stating that it was inconsistent with, and did not have the status of, regulations.

Between the first and second *Stuckless* decisions the Governor sought and obtained legislation to mandate the adoption of new regulations in this area. Regulations were proposed in accordance with this mandate on September 20, 2006.[5]

The newly proposed regulations on Stock Option Income generally provide that income in respect of statutory stock options, nonstatutory stock options with no readily ascertainable value, and stock appreciation rights will be allocated based on where the employee worked during the period between (a) the date of grant and (b) the date the option or right became exercisable. The proposed regulations generally allocate compensation from restricted stock in a manner consistent with the TSB, based on where the employee worked during the period between (c) the date when the employee acquired the stock and (d) the date on which the stock became vested. In both cases New York workdays are compared to total workdays. In the case of nonstatutory stock options with a readily ascertainable value, and restricted stock that is the subject of an election under Code §83(b), allocation follows the allocation of the regular compensation for the year in which the income is recognized.

The new regulations may create substantially different allocations than those made under the TSB. The regulations are proposed to be effective for taxable years beginning on or after January 1, 2006. However, *for 2006*, taxpayers may elect to allocate compensation essentially by following the old rules.

For years prior to 2006 it is now unclear what the rules are. Individuals who reported Stock Option Income in 2005 or earlier taxable years should consider whether the reported allocation of income could be changed, taking into account the *Stuckless* decision, other authorities regarding permissible methods of allocation, and applicable statutes of limitations.

For the future, both employers and employees will need to study the new rules in considering the optimal design of options and stock rights for specific employees, as well as the consequences of the exercise of previously issued options and rights.

Determining an appropriate course of action in light of these state tax developments will generally require in-depth consideration of the taxpayer's individual circumstances. If you have any questions or would like further information regarding the matters discussed above, please call Carolyn Joy Lee at (212) 903-8761, David E. Kahen at (212) 903-8763, Joseph Lipari at (212) 903-8765, or any of our other attorneys.

ROBERTS & HOLLAND LLP

---

[1] *Matter of Michaelson v. N.Y.S. Tax Comm'n*, 67 NY 2d 579 (N.Y. 1986).

[2] TSB-M-95(3)I.

[3] *E. Randall Stuckless and Jennifer Olson*, DTA #819319, May 12, 2005 (NYS Tax Appeals Tribunal).

[4] *E. Randall Stuckless and Jennifer Olson*, DTA #819319, August 17, 2006 (NYS Tax Appeals Tribunal).

[5] Prop. N.Y.C.R.R. §§132.24 *et seq.*, §154.6.