Originally published in:
The Tax Lawyer **August 1, 2007**

Options for Allocating Stock Option Income: New York's New Allocation Rules and Their Effect on Taxpayers, Multistate Employers, and Other States

Debra Silverman Herman

I. BACKGROUND

Determining the allocation of income from stock options for nonresidents is inherently challenging, given the difficulty in determining when the income accrues relative to the period that the nonresident performed services in the state. Recent developments in the State of New York provide some helpful guidance in understanding the nature of these issues.

Taxpayers who are nonresidents of New York and have been compensated for services performed in New York with stock options, and who have exercised the options in 2006 and earlier years, currently have significant flexibility in allocating income to New York, provided the statute of limitations is still open for those tax years. Taxpayers and counsel currently engaged in audits with the New York State Department of Taxation and Finance (Department) should be aware of their choices. Significant refund opportunities may also exist for taxpayers who have recently concluded an audit with the Department, or have voluntarily paid tax to the state based on the prior rules.

For 2007 and subsequent tax years, however, nonresidents have less flexibility in allocating stock option income to New York as a result of new allocation rules that have taken effect in New York on January 1, 2006 (N.Y. Option Income Allocation Rules).[1] These rules dictate how and when New York calculates the New York portion of income derived from stock options, stock appreciation rights and restricted stock.[2] Importantly, the method the Department has adopted in the new N.Y. Option Income Allocation Rules – that is elective for tax year 2006, but required for tax years thereafter – is one that it had not previously used to calculate the amount of income allocable to New York.

The divide between the pre- and post-2006 allocation rules reflects a long history of confusion and conflict in the allocation of nonresidents' deferred compensation income. Over the past decade, the Department, the New York administrative tribunals, and the courts have analyzed and adopted diverse allocation approaches for determining the amount of option income subject to New York tax. Part II of this Article provides an overview of these approaches through a discussion of the *In re Stuckless*[3] decisions. Each of these decisions created substantial confusion regarding how taxpayers should allocate option income between New York and other jurisdictions, due in large part to the fact that litigation tends to resolve only the specific question presented, and not to provide a comprehensive framework for taxation.

Part III of this Article sets forth the responses that New York's former Governor, and the Department, had to each of the *In re Stuckless* decisions. The end result of the back-and-forth of this particular case has been the N.Y. Option Income Allocation Rules.

Inasmuch as the N.Y. Option Income Allocation Rules adopt the general method chosen by the U.S. Treasury to calculate the amount of stock option income allocable to the United States by nonresident aliens, Part IV of this article examines the federal regulations and existing federal authority.

Part V of this Article highlights the effects of New York's new wage allocation rules and the *Stuckless* decisions on taxpayers, multistate employers, and other states. Several states currently employ the option income allocation approach challenged and rejected in *Stuckless* and in the N.Y. Option Income Allocation Rules. It is unclear whether these states will revise their methodology and adopt the allocation approach set forth in the N.Y. Option Income Allocation Rules, or will continue their current policies.

Since the new allocation approach is based upon a period of time that is shorter than the period formerly considered in New York, and still considered elsewhere, concern for the potential for double taxation that could result from dueling sourcing rules may be limited. However, because states' allocation formulae generally depend upon the relationship of New York and non-New York days during the relevant measuring period, it is possible that the application of different measuring periods may lead to adversely conflicting results.

Moreover, multistate employers need to be aware of New York's new allocation approach, since it may lead to different withholding tax liabilities. Employees will also likely request a new set of day count records from employers demonstrating working days spent inside and outside New York for the new allocation period. Finally, the *Stuckless* decisions provide an example of the importance of promulgating regulations, rather than guidance in the form of technical memoranda, since tribunals may chose, as happened in *Stuckless*, to give no deference to the taxing authorities' informal interpretation of the relevant statutes and regulations. Other states may be stuck with results far worse than New York's *Stuckless* scenario.

II. THE *STUCKLESS* DECISIONS

Mr. E. Randall Stuckless, an employee of Microsoft Corporation (Microsoft), was granted incentive stock options (ISOs)[4] in 1991 and 1992 while he worked in and was a resident of New York. On September 1, 1996, Mr. Stuckless and his wife moved to Seattle, Washington. From September 1, 1996 through July 5, 1998, Mr. Stuckless worked for Microsoft in Seattle, and during this period he exercised several of the ISOs and contemporaneously sold the stock. During that time period Mr. Stuckless was neither a resident of New York, nor an employee performing any services in New York. On July 6, 1998, Mr. Stuckless returned to New York, exercised several more ISOs, and sold the stock, while a resident of New York.

Mr. Stuckless did not file a New York income tax return for 1997; he filed a joint Nonresident and Part-Year Resident income tax return for 1998 reporting the income from the sale of stock during the resident period.[5] The Department audited Mr. Stuckless, and he was assessed tax on income he realized during the nonresident years (1997 and 1998, the Audit Period), plus interest and penalties.

The Department determined that Mr. Stuckless's income in the Audit Period constituted New York source compensation income, and that the compensation portion of the income was the difference between the option exercise price and the fair market value of the option on the date of exercise. Further, the method used by the Department to allocate the option income to New York was based on a fraction, the numerator of which was the number of New York working days from the date the option was granted to the date of exercise, and the denominator of which was the total number of days worked both inside and outside of New York for the same period. This grant-to-exercise day count allocation was the allocation methodology set forth in a Technical Services Bureau Memorandum,[6] and in the Department's District Office income tax audit guidelines[7] (the "1995 Memorandum Allocation Methodology").[8] Mr. Stuckless protested, and the following decisions ensued.

A. The Administrative Law Judge Decision

Mr. Stuckless filed a Petition with the New York State Division of Tax Appeals and asserted two main arguments: (1) New York was not entitled to tax any portion of the option income; and (2) in the alternative, the amount of option income New York was entitled to tax was limited to the amount of gain that had accrued to the date he moved from New York, as if he exercised the option on that date (i.e., the difference between the option price and the fair market value of the stock as to which he held an option on the date his employment and residency in New York ended).[9]

Administrative Law Judge Thomas C. Sacca (ALJ) rejected both of Mr. Stuckless's arguments. The ALJ determined that the option income upon which the Department assessed tax was New York source income.[10] New York, like most states, considers New York source income to include items of income, gain, loss or deduction attributable to "a business, trade, profession or occupation carried on in the state."[11] The regulations further provide that a nonresident individual rendering personal services as an employee, include the compensation for personal services entering into the individual's federal adjusted gross income, to the extent the individual's services were rendered in New York.[12] Mr. Stuckless maintained that there was no "compensation" subject to tax until the ISOs were exercised and sold during the nonresident period.[13] The ALJ, however, citing *Michaelson v. New York State Tax Commission,*[14] ruled that when determining whether option income constitutes New York source income, the activities of the taxpayer at the time the options are secured and earned (that is, date of grant) are controlling, rather than at the time when the benefit was actually received or realized (that is, date of exercise).[15] The ALJ found that the language of the plan under which the ISOs were granted demonstrated that they were intended as compensation for services Mr. Stuckless rendered to Microsoft while he was a resident of New York.[16]

Further, the ALJ stated, as set forth by the Court of Appeals in *Michaelson*, only the income from the exercise of the stock options is taxable New York compensation.[17] Thus, the ALJ concluded that the Department properly determined that the total amount of compensation subject to tax is measured based on the amount of gain incurred over the period from the date of grant of the options to the date of exercise of the options.

The ALJ also sustained the Department's use of the 1995 Memorandum Allocation Methodology. During the Audit Period, New York's statute provided (and it continues to provide) that in the case of nonresident individual employees who work partly inside and partly outside New York, the income derived from New York sources is required to be determined based on "apportionment and allocation" under [the Department's] regulations."[18] The regulations in effect during the Audit Period provided 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;[19] however, these regulations did not provide any specific guidance in regard to option income. Instead, the Department's policy for allocating the New York portion of the stock option income was set forth in a Technical Services Memorandum – the 1995 Memorandum.[20]

The Department issued the 1995 Memorandum as a direct result of the court of appeals decision in *Michaelson.* The beginning portion of the 1995 Memorandum summarizes the *Michaelson* decision, in particular the holding that the total amount of compensation subject to tax is measured based on the amount of gain incurred over the period from the date of grant of the options to the date of exercise of the options. It further states that the Department has chosen to align its allocation method for determining the portion of the compensation subject to New York tax based upon the same general measure, which it deemed the "compensable period" and is referred to herein as the 1995 Memorandum Allocation Methodology.[21] However, it limited the compensable period to the date employment ceases.

Significantly, the methodology adopted by the Department in the 1995 Memorandum represented a reversal of its historical policy, which required an allocation based upon the number of days worked inside and outside New York during the year of exercise.[22] As such, many practitioners, as well as Mr. Stuckless, have argued that the Department was required under the state's Constitution and its Administrative Procedures Act to promulgate formal regulations setting forth the new policy. Since the Department did not proceed in this fashion, the argument follows that the Department had no regulatory authority to impose the 1995 Memorandum Allocation Methodology on Mr. Stuckless and other taxpayers.

The ALJ was not impressed with this argument. He stated that the Department was not required to issue regulations, and further ruled that the allocation method set forth in the 1995 Memorandum represented a reasonable interpretation of the *Michaelson* decision, New York's statute and its regulations. Thus, the ALJ rejected Mr. Stuckless's alternative argument that the amount of option income New York was entitled to tax was limited to the amount of gain that accrued on the date he moved from New York. In other words, the ALJ refused to adopt Mr. Stuckless's position that he be treated as if his employment terminated on the date he moved to Washington. As explained above, the ALJ found that this methodology did not represent the employment benefit Mr. Stuckless received (that is, the grant of the ISOs) while he was a resident of New York.

Mr. Stuckless disagreed with this result. In response, he filed an exception, and sought review of the ALJ determination by the New York State Tax Appeals Tribunal (Tribunal).

B. Stuckless I – The Initial Tax Appeals Tribunal Decision

In May, 2005, the Tribunal rendered its first decision in *Stuckless I*. It determined that the fair market value of the stock as to which Mr. Stuckless held options on the day he moved from New York should be used to determine Mr. Stuckless's New York income tax, and it rejected the Department's use of the 1995 Memorandum Allocation Methodology.[23]

Specifically, the Tribunal ruled that the accretions in value of the stock during the period when Mr. Stuckless worked in Washington represented compensation for his work in that state and therefore was not attributable to employment in New York.[24] The ALJ's interpretation of *Michaelson* was held to be incorrect and in contravention of Tax Law §631(c) and Regulations sections 132.4(b)and(c), and 132.18. "Neither Tax Law §631(c) nor the . . . regulation (20 NYCRR 132.18) make provision for imposing tax on the income of a nonresident working in another state."[25] Thus, the Tribunal adopted Mr. Stuckless's alternative argument.

The Tribunal did disagree with Mr. Stuckless's assertion that the Department improperly issued the 1995 Memorandum, but stated that it did not view the 1995 Memorandum as legal authority.[26] Most importantly, the Tribunal held that the 1995 Memorandum Allocation Methodology simply did not apply to the facts presented, since (unlike the petitioner in *Michaelson)*[27] Mr. Stuckless was neither a resident nor performing services in New York when the option income was realized. It also held that regulations section 132.18(a), which states 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, was not applicable to the facts presented, for the same reason.[28]

The Tribunal thus ruled that Mr. Stuckless, and other taxpayers, are entitled to adopt an alternative allocation methodology. It further sustained Mr. Stuckless's alternative – the use of a mark-to-market allocation based upon workdays, and appreciation, between the date of grant of the options and the date that he left New York for Washington.

> We agree with Petitioner that his New York employment terminated on the date he moved to Washington and that the fair market value of the stock on the date he moved out of New York must be used to determine the gain realized for New York state income tax purposes.[29]

State and local tax practitioners were generally surprised by the Tribunal's adoption of a mark-to-market approach. Many envisioned scenarios in which both the 1995 Memorandum Allocation Methodology and a mark-to-market methodology could apply, with confusing results.[30] Some practitioners were also disappointed that the validity of the 1995 Memorandum had been upheld.

C. The Order on Motion For Rehearing Before The Tax Appeals Tribunal

Faced with its loss in *Stuckless I* and the resulting "confusion for the Division and tax practitioners"[31] as to when the 1995 Memorandum Allocation Methodology would apply, the Division of Taxation (Division)[32] made the rather unusual move of petitioning the Tribunal to rehear the case.[33] Under New York law, there is no statutory authority for the Tribunal to reconsider a decision. However, the Tribunal's rules expressly provide the authority to reconsider a Tribunal decision by granting a motion for reargument.[34] The purpose of this procedural mechanism, and the standard applied by the Tribunal when determining whether to grant such a motion, is whether it will "afford a party an opportunity to establish that the court overlooked or misapprehended the relevant facts, or misapplied any controlling principle of law."[35]

The Division's primary argument in its memorandum in support of its motion for reargument was that the Tribunal in *Stuckless I* had overlooked a controlling principle of law, namely a decision issued by the Court of Appeals in *Brady v. State of New York.*[36] The Division argued that *Brady* approved the use of a formula apportionment method when determining a nonresident individual's total income subject to tax, and that just such a formula apportionment method was set forth in the 1995 Memorandum. The "direct accounting method" or "mark-to-market" approach (that is, the exclusion of accretions in value while Mr. Stuckless was employed in Washington) chosen by the Tribunal in *Stuckless I,* it was argued, did not comport with *Brady*.[37] The Division thus requested the opportunity to address the principle set forth in the *Brady* decision.

The Division further argued that the "direct accounting method" adopted in *Stuckless I* incorrectly assumes that each day of work coincides with the appreciation or depreciation in the value of the stock for that day.[38] It also maintained that it would be impracticable to administer this approach, and overly burdensome on taxpayers to keep the records required.[39]

In his memorandum of law in opposition to the Division's motion for reargument, Mr. Stuckless argued that *Brady* was irrelevant to the matter.[40] Many state and local tax practitioners informally agreed. Moreover, Mr. Stuckless's main argument, as viewed by the Tribunal, was that the Division omitted any discussion of section 132.18(*b*) of the state's regulations. Specifically, section 132.18(*b*) "deals with a nonresident who severs his ties with New York and ceases to have any New York employment" and "[u]nder subparagraph (b) no income from out of state employment is taxed in New York where there is no New York employment."[41] By contrast, the Division (and the Tribunal in *Stuckless I*) addressed only section 132.18(*a*), which Mr. Stuckless explained is the provision that deals with a nonresident who "works both in and out of New York" within the same taxable year.[42]

It should be noted that section 132.18(*a*) of the regulations does not expressly state in its text that the day count allocation is limited to a taxable year, although it does provide an example of a day count calculation that is limited to the taxable year of receipt of income.[43] Nevertheless, based on the fact that he had not worked in New York one single day during the tax year in which he realized the ISO income, Mr. Stuckless argued that the 132.18(a) regulation, and the 1995 Memorandum, were irrelevant to his matter.

Significantly, Mr. Stuckless agreed with the Division that the Tribunal in *Stuckless I* had erroneously concluded that section 132.4 of the regulations authorized a permissible alternative method of allocation. The Tribunal agreed with both parties and granted the motion for reargument in December 2005.[44]

In granting reargument the Tribunal also articulated four other items that it thought should be addressed during rehearing: (1) whether *Stuckless I* properly interpreted the scope of the 1995 Memorandum; (2) whether section 132.4 of the regulations applies;[45] (3) whether the 1995 Memorandum represents an alternative method the Division is authorized to apply pursuant to section 132.24 of the regulations; and (4) if the Division was not authorized to adopt an alternative method pursuant to section 132.24 of the regulations, whether there is any legal authority for imposition of the tax assessed against Mr. Stuckless.[46]

D. Stuckless II – The Final Tax Appeals Tribunal Decision

When the Tribunal examined Mr. Stuckless's case upon rehearing and made its determination in *Stuckless II,*[47] the Division fared far worse than it had in *Stuckless I.* In general, the Tribunal ruled in *Stuckless II* that the Department had no authority to impose the multiple year 1995 Memorandum Allocation Methodology.[48] Rather, it found that the regulations authorize an allocation based solely on work days within the taxable year income is realized – a year of exercise allocation methodology. Further, the Tribunal ruled that the 1995 Memorandum was not entitled to any deference, thereby impairing the Division's ability to rely on the 1995 Memorandum in the future.[49]

Notwithstanding the Division's reliance on *Brady* (and its principles) in its memorandum in support of its motion for reargument, the Tribunal made no specific mention of the decision in *Stuckless II*, including in its summary of the Division's arguments. Instead, it detailed the following four arguments that it viewed as the Division's arguments on rehearing: (1) the ALJ determination was correct and should be sustained; (2) the date of grant of the ISOs was a crucial factor in *Michaelson* because under the Code the strike price of the option must equal the fair market value of the stock on the date of grant; (3) the 1995 Memorandum reflects *Michaelson* and is a reasonable interpretation of the state's nonresident income tax regulations; and,(4) the 1995 Memorandum Allocation Methodology is an alternative method authorized by section 132.24 of the state's regulations.[50]

According to the Tribunal, Mr. Stuckless asserted five main arguments: (1) the ALJ erred in finding the option income was secured and earned through New York employment; (2) the multiple year allocation set forth in the 1995 Memorandum and applied by the Department violated the annual accounting concept of Tax Law section 638(2), and only services rendered during the year of exercise of the options should be considered in determining New York source income; (3) regulations section 132.18(b)controls and should have been applied, rather than regulations section 132.18(a); (4) the 1995 Memorandum violates New York's State Administrative Procedure Act; and (5) the Department should have permitted a more equitable method of allocation pursuant to regulations section 132.24, in particular an allocation between the appreciation that occurred while he lived and worked in New York and the appreciation that occurred while he lived and worked in Washington.[51] Thus, Mr. Stuckless maintained his primary argument from below, but tweaked his alternative argument.

The Tribunal began its opinion with a lengthy discussion of the *Michaelson* decision. Although the Tribunal concluded that both of the issues in *Michaelson* – the character of option income (that is, capital gain or ordinary income) and the timing of recognition of option income – were not at issue in *Stuckless*, a few items are worth noting. First, New York does not provide federal capital gain treatment, as set forth in the Code, for statutory stock options or any other kind of asset, all gain is subject to tax at the same rates as ordinary income.[52]

Second, New York law conforms to federal law in regard to the timing of the recognition of gain for statutory stock options. Since the calculation of New York tax begins with federal adjusted gross income, a legislatively enacted modification would be necessary if New York were to tax statutory stock options at the same time as nonstatutory stock options (that is, taxation on the date of exercise).[53] To avoid imposing an overly burdensome recordkeeping obligation on taxpayers and administratively difficult enforcement standards on the Department, such a change has not been pursued legislatively.

Third, the Tribunal emphasized that in *Michaelson* the petitioner and the Department agreed to an allocation of the option income based solely on a day count during the year of exercise. Therefore, although the *Michaelson* decision did not expressly address the allocation issue, the Tribunal could not "find any express or implied support in *Michaelson"* for the 1995 Memorandum Allocation Methodology "when the facts before the State Tax Commission and the courts included an allocation based on a day count ratio for the year in which the income was realized."[54]

In addressing Mr. Stuckless's argument that New York's law and regulations dictate an annual mark-to-market approach in regard to the option income, the Tribunal explained that although the law (sections 638 and 639 of the New York Tax Law) and regulations (section 132.18(b)) provides a closing of the books approach when there is a change in residence, the law (Tax Law §631) and regulations (section 132.18(a)) also require a pro-ration of the income for determining source.[55] Further, the fact that the statutory accrual provision that applies when a nonresident becomes a resident of New York[56] expressly excludes New York source income from the calculation, implied to the Tribunal that the general sourcing rules are meant to apply before and independent of the change-in-residence rules.[57]

Based on this analysis, the Tribunal concluded that Mr. Stuckless's mark-to-market approach was inconsistent with the state's general sourcing rules and therefore without merit. As a result, *Stuckless II* held that the Tribunal's decision in *Stuckless I* was incorrect. Furthermore, the valuation of the ISOs on the date Mr. Stuckless moved out of New York was found to be contrary to the basic premise of the income taxation of such options: options are subject to tax if there is a readily ascertainable fair market value when granted, and if not they are subject to tax, upon exercise.[58] Based on these analyses, the Tribunal concluded that its earlier decision had to be withdrawn.

In the remaining portion of its opinion, the Tribunal articulated its new analysis of New York's law and regulations as applied to Mr. Stuckless's option income.[59] Importantly, the Tribunal highlighted the specific authority granted to the Department to promulgate regulations setting forth allocation rules for compensation income.[60] It also described some of the regulations that the Department had promulgated under this authority when the general allocation rules set forth in regulations section 132.18 produced a distortive result. For example, the Department has promulgated special rules for nonresident athletes,[61] sales people,[62] securities and commodities brokers,[63] and recipients of pensions and certain other retirement benefits.[64]

The Tribunal also emphasized that the allocation required under each of these rules, with the exception of the rule for nonresident individuals that receive pension and retirement benefits, is limited to the taxable year in which the income is received. Further, it explained that even under the pension and retirement benefit regulation, where the allocation spans multiple tax years, a separate day count calculation is required to be made for each tax year. Since the day count calculation set forth in the 1995 Memorandum Allocation Methodology is based on the entire compensable period, rather than each tax year, it follows that such allocation is contrary to New York's other regulatory provisions involving multiple year deferred compensation income.

The Tribunal also examined section 132.18(a) of the regulations, as outlined in its opinion granting the motion for reargument, and concluded that the rules and examples set forth therein "express, or strongly imply, an allocation based on work days within the taxable year in which the income is realized, subject to the flexibility afforded by section 132.4(c) and section 132.24."[65] On this basis, the Tribunal ruled that the allocation of option income by a nonresident is required to be based on the individual's New York work day count during the year in which the option income is exercised. Based on that methodology, and given that Mr. Stuckless had zero New York workdays in the year of exercise, the Tribunal concluded he owed no tax on his option income.

The Tribunal also, importantly, stated that "if the Division wishes to depart from the rules provided by those sections [of the regulations] and create a new separate set of rules for identified special circumstances, we think such a change should be effected through legislation or adopted in regulations . . ."[66] Since the Department did not promulgate regulations, but rather set forth the 1995 Allocation Methodology in the 1995 Memorandum, and since such methodology was inconsistent with the existing regulations, the Tribunal concluded that the Department had no statutory or regulatory authority to impose the 1995 Memorandum Allocation Methodology on Mr. Stuckless.

In so concluding, the Tribunal rejected the Division's argument that section 132.24 of the regulations – the provision that grants the Department the authority to require taxpayers to use an alternative to the allocation methods expressly set forth in the regulations – was sufficient authority to impose the 1995 Memorandum Allocation Methodology on Mr. Stuckless and other taxpayers. Specifically, the Tribunal ruled that section 132.24 of the regulations applies only to "accommodating ad hoc situations" when the existing regulations would produce an unfair and inequitable result.[67] The 1995 Memorandum, in contrast, "is clearly not such a special tailoring. It is a highly articulated set of rules of general application."[68]

The Tribunal thus concluded that the issues present in the *Stuckless* case were purely legal in nature, and that it could reach its determination based on its own interpretation of the statutory and regulatory authority, as applied to the agreed facts. According no deference to the 1995 Memorandum, the Tribunal ultimately handed a victory to Mr. Stuckless.

III. THE EXECUTIVE'S RESPONSES TO THE *STUCKLESS* DECISIONS

A. Governor Pataki Requests Regulations

In response to *Stuckless I*, former Governor George E. Pataki included a provision in his fiscal year 2006-2007 Budget Bill requiring the Department to issue regulations to clarify the tax treatment of option income.[69] Enactment of this provision was "necessary to implement the 2006-2007 Executive Budget."[70] The Memorandum in Support further provides:

> This bill will require the Commissioner of Taxation and Finance to issue regulations which would clarify New York State's tax treatment of stock options, restricted stock, and stock appreciation rights received by a nonresident or part-year resident taxpayer.
>
> The bill would provide that a nonresident or part-year resident, who performs services or is employed within New York, would allocate compensation income attributable to stock options restricted stock or stock appreciation rights pursuant to regulations prescribed by the Commissioner of Taxation and Finance. The bill would require that the Commissioner of Taxation and Finance propose rules and regulations within 180 days of this act becoming law and that such rules and regulations may apply to taxable years beginning on or after January 1, 2006.
>
> The recent decision by the Tax Appeals Tribunal in the *Matter of E. Randall Stuckless* has raised significant confusion for both taxpayers and the Department of Taxation and Finance as to the proper allocation of New York source income from stock options, restricted stock, and stock appreciation rights. Although the Department had developed allocation rules which were published in a Technical Services Memorandum, that memorandum was ignored by the Tribunal in *Stuckless*. As a result, there are currently no clear rules for taxpayers, practitioners and the Tax Department staff to follow. This bill would require the Commissioner to develop clear guidelines for the allocation of income from stock options, restricted stock and stock appreciation rights with input from taxpayers and practitioners pursuant to the State Administrative Procedure Act regulation process.[71]

The Legislature enacted the provision into law and the Department had 180 days to draft regulations. During this time period, the Department also awaited the result of the Tribunal's decision in *Stuckless II.*

Almost anticipating the unfavorable result of *Stuckless II*, the Budget Bill stated that the rules to be promulgated by the Department "shall be controlling for such taxable years [taxable years beginning on or after January 1, 2006] *notwithstanding any tax appeals tribunal decision to the contrary*.[72] Also, the provision the Legislature enacted set forth the statutory authority for the Department to promulgate option income regulations, which as it turned out was recommended by the Tribunal in *Stuckless II* as well.

The end result of this legislation was statutory amendments to sections 631 and 638 of the Tax Law, the sections that set forth the general income tax sourcing rules for nonresident individuals and part-year resident individuals. For taxable years beginning on or after January 1, 2006, subsection (g) of section 631 of the Tax Law (nonresidents) and subsection (c) of section 638 of the Tax Law (part-year residents) provide:

> Stock option grants, stock appreciation rights and restricted stock. A [nonresident or part-year resident]taxpayer who has been granted statutory stock options, restricted stock, nonstatutory stock options or stock appreciation rights and who, during such grant period, performs services within New York for, or is employed within New York by, the corporation granting such option, stock or right, shall compute his or her New York source income as determined under rules and regulations prescribed by the commissioner.[73]

B. The Department's Draft Regulations

1. August 2006 Draft Regulations, and the New York State Bar Association's Comment Thereon.

In fulfillment of its statutory obligation to draft regulations and obtain input from practitioners, the Department provided the Tax Section of the New York State Bar Association (NYSBA) with a draft of its regulations dated August 9, 2006 (Draft Regulations).[74] In the Draft Regulations, the Department rejected:(1) Mr. Stuckless's and the ALJ's mark-to-market workday allocation approach; (2) the Department's historical year-of-exercise workday allocation approach (which, as we know from the discussion above, the Tribunal would adopt eight days later as its chosen allocation method in *Stuckless II*); and (3) the grant-to-exercise workday allocation approach set forth in the 1995 Memorandum.[75] Instead, the Department adopted a grant-to-vesting workday allocation approach (set forth in new section 132.24). To limit the potentially harsh effect of this methodology on nonresidents who exercised options in 2006, the Department included a provision allowing them to elect to allocate option income from the date of grant of the options to the earliest of the date the option or right is exercised (the 1995 Memorandum Allocation Methodology), the date employment services terminate, or the date that the compensation is recognized for federal income tax purposes.

The NYSBA applauded the Department's Draft Regulations in a report issued on September 20, 2006 (Report).[76] In contrast to the Department when it drafted the Draft Regulations, the NYSBA had knowledge of the Tribunal's decision in *Stuckless II*, which is reflected in its Report.

In its Report, the NYSBA noted that it had suggested the grant-to-vesting approach during discussions with the Department's Regulations Bureau. It also stated that this allocation approach "makes the most sense" because it correlates with the period of time during which an employee satisfies all employment-related conditions to exercise the option or right.[77] It also conforms with the method adopted by the Internal Revenue Service for nonresident aliens.[78]

As part of its general comments in its Report, the NYSBA advised the Department to not include any carve outs from the day-counting rule set forth in the Draft Regulations (that is, a rule that no income would be allocated to New York if the employee was a nonresident during the period from date of grant to date of vesting). It also requested that the Department engage in an advertising campaign upon promulgation of the Draft Regulations to make employers aware of the new rules.[79]

The NYSBA also articulated nine specific comments in its Report, only one of which the Department adopted and included in the regulations it proposed to the public. The suggestion the Department adopted was to revise the term "federal adjusted gross" to "federal gross income" in its definition of the word "compensation" because an optionee who is not an employee (that is, independent contractor or a non-employee officer) may have federal adjustments relating to the option.[80] Of the eight remaining comments, three addressed stylistic concerns: alphabetizing the definitions, simplifying language and eliminating specific references to the Code and adopting instead a general description of certain federal tax concepts.[81]

The five remaining comments addressed substantive concerns. The NYSBA advised the Department to revise its definition of the term "compensation" to reflect the different character of income and timing rules that apply to statutory stock options under New York's law compared to federal law.[82] More significantly, it recommended that the Department include a clear definition of the term "date of vesting" since the Draft Regulations included varied language to describe the vesting concept.[83] Specifically, it advised the Department to adopt "the date the stock is vested (transferable or not subject to substantial risk of forfeiture)" as its definition throughout the regulation.[84]

Importantly, the NYSBA advised the Department to make clear that the grant-to-vesting methodology set forth in new section 132.24 is the presumptive allocation method for stock option income under the new regulations. In addition to that methodology, which was set forth in new section 132.24 of the Draft Regulations, new section 132.25 of the Draft Regulations, captioned "other methods of allocation," allows the Department and taxpayers to utilize an alternative method of allocation when the methods set forth under new section 132.24 and sections 132.15 through 132.23 of the regulations (that is, the other special allocation rules for nonresident individuals discussed above in Part II) do not result in a fair and equitable allocation. The NYSBA found that "[t]he Draft Regulation[s] in its present form suggests that the allocation method set forth in new section 132.24, like the allocation methods contained in sections 132.15 through 132.23 of the regulations, is just one of many methods and the Department auditors as well as taxpayers may feel free to apply other methods."[85] The Report also suggested that new section 132.25 be revised to make clear that taxpayers can propose an alternative allocation method other than through the filing of their personal income tax returns.[86]

Another NYSBA comment was that the regulations should expressly provide that taxpayers have an election to choose, for all open years prior to taxable years beginning on or after January 1, 2006, to apply either the 1995 Memorandum Allocation Methodology or the *Stuckless II* year-of-exercise methodology. As discussed below, the Department informally adopted this approach through a Technical Services Memorandum issued on October 12, 2006 (the "2006 Memorandum")[87]. However, adopting substantive rules through yet another Technical Services Memoranda suggests that the Department may have ignored the NYSBA's final advice in its Report, that the "Department might wish to review other situations where *amended regulations* might be necessary to effect the intention of other provisions of Technical Services Bureau Memoranda."[88] While it would be unfortunate, a new chapter in the *Stuckless* confusion may have been spawned by the Department's decision to issue an informal policy memorandum, rather than regulations, to address open tax years. This is addressed in section III.C, below.

2. October, 2006 Proposed Regulations

On October 10, 2006, the Department issued proposed regulations that were virtually identical to the August Draft Regulations (Proposed Regulations).[89] In accordance with the State's Administrative Procedure Act, the Department provided a 45-day public comment period. By this time, the public already had approximately two months to understand and analyze the Tribunal's decision in *Stuckless II;* and many practitioners in the area were well acquainted with the Draft Regulations.

As explained in its Assessment of Public Comment, the Department received written comments from a certified public accountant, a practitioner and The Business Council of New York State, Inc. (Business Council) in regard to the Proposed Regulations.[90] The accountant requested that the timing of recognition of the option income occur at vesting, rather than at exercise. For the reasons articulated above in Part II.D of this Article – conformity with federal timing rules – the Department rejected the accountant's request.[91]

The practitioner and the Business Council both advocated a year-of-exercise workday allocation approach. The Department summarized six justifications provided by the Business Council for this approach, including less recordkeeping, flexibility in the regulations promulgated under the Code that may authorize this result notwithstanding their general grant-to-vesting allocation approach, and the general opinion that the year-of-exercise rule in *Stuckless II* is a valid, reasonable and more appropriate measure for sourcing option income.[92] The Department considered these justifications and rejected them, primarily by reiterating one of the justifications cited by the NYSBA in its Report on the Draft Regulations – the rules correlate with the time period during which all service-related conditions to exercise occur, and therefore more appropriately match the compensation element inherent in the grant of the options.[93] The Department also explained that the Proposed Regulations were not meant to "entirely duplicate" the method chosen by the Service.[94] The Department's specific response is important, because it indicates how the Department might respond to a taxpayer's challenge in the future when it is based on federal authority, and because it also points to the path taxpayers should take if the one-size-fits-all regulation proves to be a poor fit:

> The Internal Revenue Code sourcing rule for nonresident aliens was viewed by the Department as a reasonable and fair apportionment for stock option income, but federal conformity was not the Department's main goal. The proposed regulation does not entirely duplicate the IRS sourcing rule, which provides a great deal of flexibility dependent upon an individual's facts and circumstances. The proposed regulation provides a specific rule which applies to everyone. In situations where the proposed rule may produce an unfair result, the Department's regulations already provide individuals with an option to use an alternate allocation that would more fairly apportion their New York source income (section 132.25).[95]

3. December, 2006 Final Regulations – The New N.Y. Option Income Allocation Rules.

On December 12, 2006 the Department adopted the October Proposed Regulations, with one slight change.[96] The definition of the term "New York workday fraction" now says:

> a 'New York workday fraction' is a fraction the numerator of which is the number of days worked within New York State *for the grantor* during the allocation period and the denominator of which is the number of days worked both within and without New York State *for the grantor* during the allocation period.[97]

The term "grantor" is generally defined as the corporation granting such options, rights or stock, as set forth in the Draft Regulations and Proposed Regulations.[98] The insertion of this language raises a question whether the performance of services for an entity other than the corporation that granted the stock options or rights enters into the day count allocation; inasmuch as individuals may well hold options to purchase a publicly-traded parent's shares while working for an affiliate, this is not an idle concern.

The final N.Y. Option Income Allocation Rules, effective for 2006 and subsequent years, thus 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 (1) the date of grant and (2) the date the option or right became exercisable (date of vesting). Income from restricted stock will generally be allocated based on where the employee worked during the period between (1) the date when the employee acquired the stock and (2) the date on which the stock became vested. Under each approach, the comparison will be New York workdays to total workdays. Further, in regard to nonstatutory stock options with a readily ascertainable value, or restricted stock for which an election has been made under section 83(b), the workday allocation is based on the New York and total workdays in the year in which the income is recognized for federal tax purposes. For tax year 2006, however, taxpayers may elect the date-of-grant-to-date-of-vesting allocation approach, or the period from the date of grant to the earliest of the date that the option or right is exercised, the date that employment terminates, or the date that the compensation is recognized for federal income tax purposes.

C. Technical Services Bureau Memorandum Regarding 2005 and Earlier Years – TSB-M-06(7)I

On October 12, 2006, subsequent to the issuance of its Proposed Regulations and prior to the promulgation of the final regulations, the Department issued a Technical Services Bureau Memorandum entitled *Revised New York Tax Treatment of Stock Options, Restricted Stock and Stock Appreciation Rights Received by Nonresidents and Part-Year Residents* (the 2006 Memorandum).[99] The 2006 Memorandum authorizes taxpayers to utilize the allocation methodology adopted in *Stuckless II*, *or* the 1995 Memorandum Allocation Methodology, for tax year 2005 and earlier years, where the statute of limitations is still open. Thus, taxpayers who filed tax returns for 2005 or earlier years may wish to amend their tax returns to reflect an alternate method of allocation.

For open years, some observers have questioned whether the 1995 Memorandum Allocation Methodology is alternatively permissive or required, assuming it is determined that the "general rule" of year-of-exercise should not apply.[100] The Department largely answered this question in the following language in the 2006 Memorandum:

> For full year-nonresidents, the general rule is that the nonresident uses the days-in-and-out allocation for the tax year the options or rights were exercised or the restricted stock vested (or, if earlier, the year the stock was sold) as set forth in section 132.18 of the regulations. The Department will accept, however, the use of the grant to exercise method explained in TSB-M-95(3)I as an alternative method. There may be special circumstances where the allocation for the year of exercise or vesting does not result in a fair and equitable allocation. *For example, the Department recognizes that where an employee exercises stock options and leaves the employment of the company that granted the stock options early in that year, using the allocation in effect for the year the options are exercised may not result in a fair and equitable allocation of the option income.* In this situation, it may be necessary to use an alternative allocation such as the one set forth in TSB-M-95(3)I. [101]

IV. THE FEDERAL RULES

The method adopted by the Department mirrors the general rule set forth in Treasury Regulations, effective for federal income tax purposes beginning in 2006 for determining the source of multi-year compensatory option income for services performed by nonresident aliens within and without the United States. In general, the federal method is a time-based approach over an "applicable period," where the applicable period is determined on a "facts-and-circumstances basis."[102] In regard to option income, the facts and circumstances are presumed to relate to an applicable period consisting of the period between the grant of an option and the date of vesting of the option. Specifically, Regulation section 1.861-4(b)(2)(ii)(F) states:

> Multi-year compensation arrangements: The Source of multi-year compensation is determined generally on a time basis, as defined in paragraph (b)(2)(ii)(E) of this section, over the period to which such compensation is attributable. For purposes of this paragraph (b)(2)(ii)(F), multi-year compensation means

> compensation that is included in the income of an individual in one taxable year but that is attributable to a period that includes two or more taxable years. The determination of the period to which such compensation is attributable, for purposes of determining its source, is based upon the facts and circumstances of the particular case. For example, an amount of compensation that specifically relates to a period of time that includes several calendar years is attributable to the entirety of that multi-year period. The amount of such compensation that is treated as from sources within the United States is the amount that bears the same relationship to the total multi-year compensation as the number of days (or unit of time less than a day, if appropriate) that labor or personal services were performed within the United States in connection with the project bears to the total number of days (or units of time less than a day, if appropriate) that labor or personal services were performed in connection with the project. *In the case of stock options, the facts and circumstances generally will be such that the applicable period to which the compensation is attributable is the period between the grant of an option and the date on which all employment-related conditions for its exercise have been satisfied (the vesting of the option).*[103]

Although the general allocation sourcing rule set forth above is substantially similar to the new sourcing rule set forth in the N.Y. Option Income Allocation Rules the federal provision by its terms is a "facts and circumstances test." As discussed above, the Department therefore takes the position that the federal rule "does not entirely duplicate the IRS sourcing rule, which provides a great deal of flexibility dependent upon an individual's facts and circumstances."[104] As such, federal authority may not be extremely helpful when challenging or substantiating a taxpayer's allocation position on the state level.[105]

The Treasury Regulations were recently promulgated, and there has been as yet no further guidance from the Service discussing their application to specific taxpayers. Taxpayers and their counsel can however look to rulings issued by the Service that predate the regulations, where it adopted the same approach.[106]

Significantly, in 2005, the Organization for Economic Cooperation and Development (OECD) issued an updated version of its model treaty (the Model Tax Convention) and commentary.[107] Included within the updated commentary are recommendations for common tax treaty approaches to employee stock options. With respect to employment services that are provided in more than one country, the commentary provides that "the only days of employment that should be taken into account are those that are relevant for the stock option plan, e.g., those during which services are rendered to the same employer or to other employers the employment by whom would be taken into account to satisfy a period of employment required to acquire the right to exercise the option."[108] Thus, the OECD also chose the grant-to-vesting period as the "most appropriate one" when an allocation is necessary as a result of the performance of services in multiple jurisdictions. It will be interesting to see how many international jurisdictions adopt this method. Within the same month that the OECD adopted its commentary, Belgian Tax Authorities aligned their commentary to reflect the grant-to-vesting rule.[109]

V. EFFECT ON TAXPAYERS, MULTISTATE EMPLOYERS, AND OTHER STATES

The number of working days within and without New York between the date of grant of statutory stock options, nonstatutory stock options with no readily ascertainable value and stock appreciation rights, and the date the options and rights are vested has significant consequences for tax year 2007 (for tax year 2006 the consequences are less significant since taxpayers have a choice) and subsequent years for nonresident employees and part-year employees. The key questions that should be considered in connection with such day counts are whether and how such employees who have as yet unvested options and, employees who relied on the former regulations, or the 1995 Memorandum, and contemplated that days between vesting and exercise would "count," should be subject to tax in New York.

If an employee limits the number of working days in New York for the entire grant-to-vesting period, then a limited amount of the option income would be subject to New York tax. However, the employee might not have much flexibility in limiting the number of days spent in New York during this period, since it is the period during which all employment-related conditions must occur to allow the employee the right to exercise the options. Presumably, the grant of an option to purchase the employer's stock as compensation for services rendered in New York assumes the performance of services in New York. Accordingly, if the employee is to achieve the economic advantages of the grant of the options (that is, participation in the appreciation in the stock's value that occurs from the date of grant), the employee must perform services wherever the employer expects, including in New York. As such, it may be difficult for employees to limit their New York tax exposure, unless the employer allows the employee to primarily perform services outside New York during the entire grant-to-vest period.

It is also important to note New York's general wage allocation rules which employ a "convenience of the employer" test under which all of the employee's income may be allocated to New York, unless the employee is able to prove that he or she performed work away from the employer's location due to employer necessity.[110] The convenience of the employer test is often juxtaposed with the "physical presence test" where employee income is allocated to the employee's location at the time the work was performed.

Although the Department has recently revised, and more importantly relaxed, its position concerning the application of the convenience of the employer test to certain nonresident and part-year resident telecommuters and other nonresidents and part-year residents that meet certain requirements, the new regulations do not expressly or impliedly adopt the favorable position. Instead, the new regulations direct taxpayers to the regulation that imposes the convenience of the employer test for guidance on determining how to compute the day count (i.e., the New York work day fraction) under the regulations. This means that "the number of days worked in New York" under the N.Y. Option Income Allocation Rules is likely subject to the convenience of the employer test, and not based purely on the taxpayer's physical presence. Thus, certain days that a taxpayer asserts are non-New York days based on the taxpayer's physical presence in another state, may be challenged by the Department on audit and recharacterized as New York days, on the basis that the work was done outside New York for the convenience of the employee. Once again, the Department has implemented its changes to the state's general wage allocation rules, through the issuance of a Technical Service Bureau Memoranda, rather than through the promulgation of regulations. As such, courts may narrowly decide that the Department's revised "convenience of the employer" position does not apply in the area of stock option income taxation, or more broadly decide, as in *Stuckless*, that the Department has no statutory or regulatory authority to apply such rules on taxpayers. Under either scenario, the taxpayer may be precluded from determining its day count based on physical presence, unless the taxpayer provides documentation to support presence outside the state due to employer necessity. Since the 2006 Memorandum does not specifically address the issue, it seems likely that the Department would apply the convenience of the employer test to all open years when determining the portion of option income that should be allocated to New York.

Notwithstanding the above, taxpayers and their counsel should be pleased that the Department issued the 2006 Memorandum because it provides a practical and flexible approach for determining the amount of option income allocable to New York for tax years prior to tax year 2006. As discussed above, taxpayers can apply the rule of *Stuckless II* (day count during the year of exercise), or can follow the 1995 Memorandum Allocation Methodology for tax year 2005 and earlier open years. In light of this option, taxpayers and their counsel should perform both calculations, to determine what position should be advocated on audit (if applicable), or to determine whether a claim for refund for tax paid to the state should be pursued.

In general, under New York law, a claim for refund must be filed within three years from the date the tax return was filed or two years from the date the tax was paid, whichever period expires later.[111] If the taxpayer did not file a tax return, then the claim for refund must be filed within two years from the date the tax was paid. Further, the amount of the refund may not exceed the amount of tax paid within the applicable two-or-three year period preceding the filing of the claim. To succeed, the taxpayer must provide sufficient documentation to the Department to prove his or her days worked inside and outside New York for the relevant period.

Similarly, on a going forward basis, taxpayers should ensure that they retain the proper records to document their working days within and without New York during the period from grant to vesting for the options or rights. Since the allocation period set forth in the new regulations spans a lesser period of time than the 1995 Memorandum Allocation Methodology, most nonresident employees who have already received their compensatory options and rights should not be significantly affected by the recordkeeping, given that they already had a duty under New York law to keep track of their working days within and without New York for this period and for general wage allocation purposes.

Residents, however, persistently suffer from a lack of knowledge of their recordkeeping obligations. If the *Stuckless* saga does no other good, perhaps it serves as a wake up call to employees who are granted options while residents of New York, but *might* eventually exercise them while resident elsewhere. Specifically, residents of New York who have been compensated with options in exchange for services rendered in New York should obtain and retain diaries, expense reports, and other records necessary to document their working days within and without New York during the period from grant to vesting if there is any chance they might change their state of residence prior to the exercise of their options.

There are tax consequences to the employer, as well as the employee, as a result of these developments. The employer's primary tax concern is whether it has withheld the proper amount of tax due. Under New York law, an employer is required to withhold an amount that is "substantially equivalent" to the amount of tax due.[112] An amount calculated under the old rules (which as noted are not themselves all that clear) may not sufficiently satisfy the employer's New York withholding tax duties under the new rules. Employers should therefore review and revise their practices to capture the specific period mandated in the final regulations: grant-to-vesting. In addition, employers may wish to inform their employees of the new rules, to alert them to the recordkeeping necessary to comply with New York's tax laws.

A different problem lies with other states that currently employ an allocation approach different from grant-to-vesting.[113] If these states do not revise their rules, (based, for example, on the justifications articulated by New York, the Service and the OECD) then there is a potential for mismatch. Specifically, if the source state (New York) and the state of residence (Connecticut)[114] use different fractions for determining the amount of the New York source income, then (rate differences aside) the credit allowed by the state of residence could be more or less than the tax imposed by a source state. For example, if an employee has 300 New York workdays out of a total 600 work days from grant to vesting, New York will tax one-half of the option income. But if that same employee works 400 days in New York out of a total 1,000 days between grant and exercise, Connecticut would consider only 40% of the income as New York sourced. In that case, 10% of the income might be double taxed.

Given the vast amounts of income generated by stock options these days, this is a potentially very real problem. States that do not currently have option income allocation rules may wish to promulgate regulations, and hope to avoid the *Stuckless* mess. Similarly, it may be prudent for taxing authorities in other states to formalize their policies currently set forth in technical memoranda or opinions, through formally promulgated regulations. This would allow courts and other administrative tribunals the opportunity to defer to such policies, provided they are reasonable and within the scope of the relevant statute under which they are promulgated. It would also, very importantly, allow taxpayers the opportunity to comply with the law, since taxpayers would understand the taxing authority's interpretation and approach to enforcement of the law.

VI. CONCLUSION

There are several relevant time periods when a state may impose tax on the benefits resulting from stock options, stock appreciation rights and restricted stock. These include taxing the employee on the date of grant, the date of vesting, the date of exercise, or the date of the sale of the underlying stock acquired under the options. There also are legitimate questions regarding the portion of the employee's income that should be considered compensation income, versus investment income. While interesting, these questions are not the primary focus of this Article, but are considered in a limited fashion inasmuch as they were addressed in *Michaelson* and *Stuckless*, and involve the same theoretical issues that states and taxpayers must consider in determining the proper amount of income that should be allocated to a particular state, when the taxpayer has performed services in multiple states over the course of the various timing events set forth above. This article addressed a subset of the broader picture – one state's and one taxpayer's, struggle to find an appropriate method for allocating compensation income, once the timing and amount of that income are established.

At the heart of the complexity of this issue lies the fact that, unlike periodic compensation, compensation paid in the form of stock options, restricted stock and stock appreciation rights often represents compensation for services that are rendered over many years, and in more than one location. It also is often unclear whether the options have been granted purely in exchange for the performance of future services, or in part in recognition of past services. In addition, income from these forms of compensation may be recognized in a tax year in which the individual's work patterns, and even residence, differ markedly from the prior years to which the compensation relates.

According to New York, the Service and the OECD, the grant-to-vesting methodology most closely tracks the underlying services that give rise to the option income. Although some observers might agree that this represents a reasonable approach, other observers may contend that New York's former rule was the more appropriate approach, because it more closely relates to the purpose for which employers have granted the compensation – to allow the employee to share in the appreciation in the employer's stock. Options granting the right to buy stock tomorrow at today's price only pay off and benefit the employee if the company's stock value increases. Since the goal of this form of compensation is generally to align the employees' interests with those of shareholders, it can be argued that taxation, including the sourcing of the compensation, should reflect the same principle.

Furthermore, although not required by law, employee stock option plans often provide for the lapse of options, even vested options, upon the termination of employment of the employee. Where that is the parties' "deal," it reflects a notion that compensatory stock options are compensation for the entire period of employment, and that the right to participate in the growth of the employer's stock, without risking capital, coincides with (and should be allocated by reference to) the entire period of employment.

But, at least in New York, that ship has sailed. This Article seeks not to present the case in favor or against any one method of allocating option income, but instead to educate taxpayers, employers and states of the concepts that are considered when determining the source of compensatory option income, and to highlight the importance of having rules in place to resolve uncertainty in this complex area. Individuals and employers with ties to New York need to review these shifting rules, and their application to past, current and future tax years, and need to demonstrate the working days spent inside and outside New York during the relevant period. Individuals and employers implicated by the laws in other states need to examine their rights and responsibilities under those laws. And everyone needs to be aware of the potential for mismatch, and of the added expense any state income tax may entail given the bite of the federal alternative minimum tax. Employers in particular should be cautious about avoiding withholding tax penalties as a result of improper withholding.

Yes, it is a mess. But one thing is certain: for tax years beginning on or after January 1, 2006, New York is no longer stuck with the *Stuckless* confusion. Or is it?

[1] N.Y. Comp. Codes R. & Regs. tit. 20, §§132.24-24, 154.6 (2006).

[2] For purposes of this Article, the term "option income" will generally refer to these different types of deferred compensation for which allocation may be necessary. *See infra* note 4 (describing generally the federal income tax treatment for statutory stock options, nonstatutory stock options, and restricted stock).

[3] *In re* Stuckless (*Administrative Law Judge Decision),* DTA No. 819319, 2004 N.Y. Tax LEXIS 148 (Div. Tax App. July 8, 2004); *In re* Stuckless (Stuckless I), DTA No. 819319, 2005 N.Y. Tax LEXIS 113 (N.Y. Tax App. Trib. May 12, 2005); *In re* Stuckless, DTA No. 819319, 2005 N.Y. Tax LEXIS 287 (Dep't Tax'n & Fin. Dec. 15, 2005) (withdrawing *Stuckless I* in Order on Motion For Reargument); *In re* Stuckless *(Stuckless II),* DTA No. 819319, 2006 N.Y. Tax LEXIS 171 (N.Y. Tax App. Trib. Aug. 17, 2006).

[4] Incentive stock options ("ISOs") are one of two types of employee stock options for which the Code provides favorable federal tax treatment, and therefore are referred to as "statutory stock options." *See* I.R.C. §423 (providing favorable federal income tax treatment for options granted under an employee stock purchase plan). ISOs must be granted under a plan that meets the requirements set forth in section §422. If the ISOs qualify, 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 (the later of two years from the date of option grant or one year from the date of exercise) prior to exercise, the appreciation recognized upon the subsequent sale of the stock is treated for federal income tax purposes as capital gain for federal income tax purposes. I.R.C. §422(a)(1). Mr. Stuckless's ISOs were granted under a document captioned "Microsoft Corporation 1991 Stock Option Plan." *Administrative Law Judge Decision*, 2004 N.Y. Tax LEXIS 148, at *7. This plan satisfied the requirements set forth in section §422, and Mr. Stuckless recognized income on the date of sale of the stock.

In contrast to ISOs, "nonstatutory stock options" (or, nonqualified stock options") are not subject to the same restrictions set forth under the Code (*i.e.*, I.R.C. §§422-423), and therefore, are not eligible for the same timing and character of income treatment. However, employees that receive these options may be able to defer tax under the Code. I.R.C. §83. In general, an employee recognizes gain on the grant of the nonstatutory options if the options have a readily ascertainable fair market value. More commonly, employees recognize compensation income upon the exercise of the options, measured by the excess of the fair market value of the optioned shares over the option exercise price. I.R.C. §83(a). Thereafter, the appreciation recognized on the sale of the stock is treated as gain derived from the sale of the stock. I.R.C. §§1001, 1221, 1222.

In regard to "restricted stock," absent an election under section 83(b), the value of the stock is not included in income until the stock either becomes transferable or fully vested. I.R.C. §83(a). At that point, the value is included as ordinary income. Any appreciation that occurs 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. If the employee makes an election under section 83(b) to include the value of the stock in income upon grant, that amount is compensation in the year of receipt, and all subsequent appreciation is treated as capital gain. I.R.C. §§1001, 1221, 1222.

[5] This is as a result of states' general personal income tax schemes that constitutionally tax all income from whatever source derived while the taxpayer is a resident of the state. Thus, New York income tax was paid on the option income associated with the exercises and sales that occurred during the resident period, and Mr. Stuckless did not protest this payment on appeal.

[6] N.Y. Dep't of Tax'n & Fin., *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 the *1995 Memorandum*].

[7] *N.Y. Dep't of Tax'n & Fin., Income Tax District Office Audit Manual, Section HN.8.1.12* (Nov. 26, 1997).

[8] The 1995 Memorandum Allocation Methodology for purposes of this Article means an allocation calculated by multiplying the income attributable to the option by a fraction, the numerator of which is the total days worked by the employee in New York during the period from the date of grant of the option to the date of exercise of the option (or to the date of termination of employment), and the denominator of which is the total days worked by the employee inside and outside New York during that same period.

[9] *Administrative Law Judge Decision*, 2004 N.Y. Tax LEXIS 148, at *12-15.

[10] *Id.* at *27.

[11] N.Y. Tax Law §631(b)(1)(B)(McKinney 2006).

[12] N.Y. Comp. Codes R. & Regs. tit. 20, §132.4(b)(2006).

[13] *Administrative Law Judge Decision*, 2004 2004 N.Y. Tax LEXIS 148, at *12-15.

[14] 496 N.E. 2d 674 (N.Y. 1986).

[15] *Administrative Law Judge Decision*, 2004 N.Y. Tax LEXIS 148, at *12-20.

[16] *Id.*, at *13-15.

[17] In *Michaelson v. New York State Tax Commission*, the Court of Appeals analyzed whether the exercise of an option is a separate realization event from the ultimate sale of the stock and whether either or both events result in the imposition of New York tax. 496 N.E.2d 674 (N.Y. 1986). The Court of Appeals ruled that the exercise of an option is a separate realization event from the ultimate sale of the stock and only the income from the exercise of the stock option is subject to New York income tax as compensation. *Id.* at 584; *see also infra* p. 999 (providing the New York State Tax Appeals Tribunal's interpretation of the *Michaelson* decision). In contrast, any gain realized as a result of an increase in the market value of the stock between the time the employee exercises the options and the ultimate sale of the stock is investment income rather than compensation. *Id.* at 585. Therefore, the gain cannot be attributable to the employee's occupation in New York and cannot be taxed by the state as New York source income. The court of appeals further held that even though the compensation element is realized on the date the option is exercised, the compensation is not subject to New York tax until the gain is recognized for federal tax purposes (*i.e.*, on the date of the sale of the stock). *Id.* at 583-84.

[18] N.Y. Tax Law §631(c) (McKinney 2006); *see also infra* note 60.

[19] N.Y. Comp. Codes R. & Regs. tit. 20, §132.18 (2006); *see infra* note 42 (providing relevant text of regulation).

[20] 1995 Memorandum, *supra* note 6.

[21] *Id.* at 2; *see supra* note 8.

[22] *See, e.g.*, *In re* Tobin, TSB-H-83(43)I, 1983 WL 20435 (N.Y. Tax Comm'n (Jan. 24, 1983).

[23] *Stuckless I,* DTA No. 819319, 2005 N.Y. Tax LEXIS 113, at *31 (N.Y. Tax App. Trib. May 12, 2005).

[24] *Id.* at *36-40.

[25] *Id.* at *35.

[26] *Id.* at *34-35.

[27] *Michaelson v. N.Y. Tax Comm'n*, 496 N.E.2d 674 (N.Y. 1986). This assumes that the 1995 Memorandum and the 1995 Memorandum Allocation Methodology set forth therein were based on the facts of *Michaelson*.

[28] *Stuckless I,* 2005 N.Y. Tax LEXIS 113, at *35-38.

[29] *Id.* at *38 (citing N.Y. Comp. Codes R. & Regs. tit. 20, §132.24 (2006)).

[30] Option income often represents compensation for services performed over many years and in more than one jurisdiction. Would the 1995 Memorandum apply to some years and the mark-to-market approach to other years?

[31] *In re* Stuckless, DTA No. 819319, 2005 N.Y. Tax LEXIS 287, at *4 (Dep't Tax. & Fin. Dec. 15, 2005) (withdrawing *Stuckless I* in Order on Motion For Reargument).

[32] The Division of Taxation is a division of the Department and the party defending the Department's assessments in the *Stuckless* decisions.

[33] *Stuckless*, 2005 N.Y. Tax LEXIS 287.

[34] N.Y. Comp. Codes R. & Regs. tit. 20, §3000.16(c)(2006).

[35] *Stuckless*, 2005 N.Y. Tax LEXIS 287, at *3.

[36] 607 N.E.2d 1060 (N.Y. 1992)

[37] Specifically, the Tribunal explained the Division's argument, in relevant part, as follows:

> The memorandum states that this is an appropriate case for reargument because the Tribunal's decision overlooked a controlling principle of law as affirmed by the Court of Appeals in *Brady v. State of New York* (80 NY2d 596, 592 NYS2d 955, *cert. denied* 509 US 905, 125 L Ed 2d 692), which was not previously argued by the parties or addressed in the Tribunal's decision. In *Brady*, the court rejected a constitutional challenge to changes in the personal income tax which were enacted in 1987. Under the 1987 amendments, the tax calculation for a nonresident of New York was to be based on the taxpayer's total income determined as if the taxpayer were a resident of New York and then that income was to be apportioned to New York. By contrast, the prior method began with New York source income as if it were the taxpayer's only income. The court rejected the assertion that the new method violated the Due Process Clause and the Equal Protection Clause of the Fourteenth Amendment of the United States Constitution and the Privileges and Immunities Clause. According to the Division, the Tribunal's decision in *Matter of Stuckless* (Tax Appeals Tribunal, May 12, 2005) excludes from the tax calculation 'accretions in value to the stock options while petitioner was employed' outside New York under a 'direct accounting method' that is inconsistent with the 'formula apportionment' method approved in *Brady.* The latter method contemplates a determination of total income from all sources followed by the allocation of that income to New York and

elsewhere. The memorandum then states that the 'Division's application of a formula apportionment method to petitioner's income was permissible and reasonable' citing numerous decisions of the Supreme Court of the United States holding that formula apportionment methods do not violate the United States Constitution (Division's memorandum in support of motion, p. 7).

Stuckless, 2005 N.Y. Tax LEXIS 287, at *4-6.

38 The Division further argued that "[f]ollowing the price of the employer's stock in the daily newspapers tables is not, in the Division's view, a sound way of measuring petitioner's work." *Id.,* at *6-7. What is omitted, or at least omitted from the Tribunal's decision, is how tracking the price on the date of exercise of the stock option differs in any meaningfully substantive way. Such an argument is present, however, in the Tribunal's decision in *Stuckless II*, where it explains that the basic premise of income taxation of the options is that they have no ascertainable market value prior to their exercise. *See infra* Part D.

39 *Stuckless*, 2005 N.Y. Tax LEXIS 287, at *6.

40 *Id.*

41 *Id.* at *7*; see also* N.Y. Comp. Codes R. & Regs. tit. 20, §132.18(b) (2006), which provides in relevant part as follows:

> Where a nonresident employee (including corporate officers, but excluding employees provided for in section 132.17 of this Part) performs services both within and without New York State for only part of a taxable year, his income derived from New York state sources during that period includes only that portion of compensation received during the period he performs services both with and without New York State, multiplied by a fraction the numerator of which is the number of days he worked within New York State and the denominator of which is the number of days he worked both within and without New York State during the period he was required to perform services both within and without New York State.

42 *Stuckless*, 2005 N.Y. Tax LEXIS 287, at *7; *see also* N.Y. *Comp*. Codes R. & Regs. tit. 20, §132.18(a) (2006), which provides in relevant part:

> If a nonresident employee (including corporate officers, but excluding employees provided for in section 132.17 of this Part) performs services for his employer both within and without New York State, his income derived from New York State sources includes that proportion of his total compensation for services rendered as an employee which the total number of working days employed within New York State bears to the total number of working days employed both within and without New York State.

43 N.Y. Comp. Codes R. & Regs. tit. 20, §132.18(a)(2006).

44 *Stuckless*, 2005 N.Y. Tax LEXIS 287, at *9-10.

45 N.Y. Comp. Codes R. & Regs. tit. 20, §132.4(c)(2006)provides:

> If personal services are performed within New York State, whether or not as an employee, the compensation for such services includible in Federal adjusted gross income constitutes income from New York State sources, regardless of the fact that (1) such compensation is received in a taxable year after the year in which the services are performed, or (2) such compensation is received by someone other than the person who performed the services.

46 *Stuckless*, 2005 N.Y. Tax LEXIS 287, at *10

47 *Stuckless*, DTA No. 81939, 2006 N.Y. Tax LEXIS 171, at *48-49 (N.Y. Tax App. Trib. Aug. 17, 2006).

48 *Id* at *40-44.

49 *Id.*, at *44-49.

50 *Id.*, at *16-17.

51 *Id.*, at *14-16.

52 *Id.*, at *23-26; *see supra* note 4 (describing generally the federal tax treatment of statutory stock options, nonstatutory stock options, and restricted stock).

53 That modification would increase New York adjusted gross income in the year of exercise of the ISOs, and reduce income in the later year of sale. *See Stuckless II,* 2006 N.Y. Tax LEXIS 171, at *24-26.

54 *Id.*, at *33.

55 *Id.*, at *34-36.

56 N.Y. Tax Law §639(b)(McKinney 2006).

57 *Stuckless II*, 2006 N.Y. Tax LEXIS 171, at *35-37.

58 *Id.*, at *37-38.

59 *Id.*, at *38.

[60] *I.d.* (stating "[i]f a business, trade, profession or occupation is carried on partly within and partly without this state, as determined under regulations of the tax commission, the items of income, gain, loss and deduction derived from or connected with New York sources shall be determined by apportionment and allocation under such regulations". (citing N.Y. Tax Law §631(c) (McKinney 2006))).
[61] N.Y. Comp. Codes R. & Regs. tit. 20, §132.22 (2006).
[62] N.Y. Comp. Codes R. & Regs. tit. 20, §132.17 (2006).
[63] N.Y. Comp. Codes R. & Regs. tit. 20, §132.21 (2006).
[64] N.Y. Comp. Codes R. & Regs. tit. 20, §132.20 (2006). Congress recently extended federal legislation that prohibits states from taxing nonresident retirees on certain pension income to non-resident and part-year resident partners. New York recently issued a memorandum explaining the federal legislation and corresponding New York tax changes. *See* N.Y. Dep't of Tax'n & Fin., *Changes to New York Tax Treatment of Certain Retirement Payments Made to Nonresident and Part-Year Resident Partners*, TSB-M-07(2)I (Jan. 24, 2007).
[65] *Stuckless II*, 2006 N.Y. Tax LEXIS 171, at *41.
[66] *Id.*
[67] *Id.*, at *44.
[68] *Id.* at 45.
[69] S. 6460, A. 9560, (2006) Leg. (2006)(Part QQ §3, *available at* http://www.budget.state.ny.us/archive/fy0607archive/0607archive.html (see link for Article VII Revenue Bill).
[70] Memorandum in Support of State of New York 2006-2007 Executive Budget Bill, Budget Implications, Part QQ, *available at http://www.budget.state.ny.us/archive/fy0607/archive/fy0607artVIIbills/REVENUEConsBMwtoc.html*
[71] *Memorandum in Support of State of New York 2006-2007 Executive Budget Bill, Summary of Provisions, Existing Law, Prior Legislative History and Statement in Support, Part QQ*, available at http://www.budget.state.ny.us/archive/fy0607archive/fy0607artVIIbills/REVENUEConsBMwtoc.htm..
[72] S. 6460, A. 9560, 2006 Leg. (2006), Part QQ §3 (emphasis added), *available at* http://www.budget.sate.ny.us/archive/fy0607archive/0607archive.html (see link for Article VII Revenue Bill).
[73] N.Y. Tax Law §§631, 638 (McKinney 2006).
[74] N.Y. Bar Ass'n, Tax Section, *Report No. 1117, Report on Proposed Regulations Under Tax Law Sections 631(g) and 638(c) (Stock Options, Stock Appreciation Rights and Restricted Stock* (2006)[hereinafter *NYSBA Report*](providing the text of the Department's Draft Regulations and comments thereto).
[75] *Id*., *app. at 2-4.*
[76] *Id.* at 6.
[77] *Id.* at 6.
[78] *Id.*
[79] *Id.* at 7.
[80] *Id.* at 8.
[81] *See id.* at 7 (suggesting alphabetical order for definitions); *id.* at 9 (suggesting elimination sections 83(a), 83(b), 422, and 423); *id.* (suggesting "the phrase 'that same period of time that applies to regular, non-stock based remuneration from the grantor during the taxable year . . .' could be replaced by 'during the taxable year of the employee'" for subparagraphs (i), (ii) and (iii) of the definition of the term "Allocation Period").
[82] *See id.* at 8.
[83] *Id.* 9.
[84] *Id.*
[85] *Id.* at 9.
[86] *Id.* at 10-11.
[87] *See infra* note 99.
[88] *NYSBA Report*, at 11 (emphasis added).
[89] N.Y. Tax Law §§631(g), 638(c) (McKinney 2006) (proposed Oct. 10, 2006).
[90] N.Y. Dep't Tax'n & Fin., Assessment of Public Comment I, *available at* http://www.tax.state.ny.us.htm [hereinafter Assessment of Public Comment].
[91] *Id.* at 1-2.
[92] *Id.* at 2-3. The Assessment of Public Comment expressly provides the following six reasons for the Business Council's position:

> (1) The year-of-exercise rule in *Stuckless* is a valid, reasonable and appropriate measure for sourcing stock option income; (2) Stock option income is earned in the year that the employee decides to

exercise the options, which is commonly based solely on the market increase in the stock value; (3) The year-of-exercise method would impose less recordkeeping requirements for both employees and employers than either the grant-to-vest or grant-to-exercise methods; (4) Although the Internal Revenue Code has a grant-to-vest provision for U.S./foreign sourcing of income, it does not have such provisions for taxpayers with only U.S. source income from stock options. If federal conformity is the main goal of the Department, then employers should be permitted to use any reasonable method including looking at only the year of exercise for administering their stock option programs, provided they do so on a consistent basis; (5) The standard most contemporary in transpiration of time (that is, the year of exercise) with realization of income would enhance compliance, accuracy, efficiency, and auditability; (6) To prevent confusion, the proposed regulation should contain expanded definitions of the types of deferred compensation covered by the sourcing rule. Companies have many different types of deferred compensation programs which are similar to stock options and stock appreciation rights, such a[s] restricted stock units and phantom stock, which should be covered by these rules.

Id. at 2-3.

[93] *Id.* at 3.

[94] *Id.* at 4.

[95] *Id.*

[96] N.Y. Comp. Codes R. & Regs. tit. 20, §§ 132.24, 132.25 & 154.6 (2006).

[97] N.Y. Comp. Codes R. & Regs. tit. 20, §132.24(c)(2)(2006) (new language in italics).

[98] N.Y. Comp. Codes R. & Regs. tit. 20, §132.24(a) (2006).

[99] N.Y. Dep't of Tax'n & Fin., *Revised New York Treatment of Stock Options, Restricted Stock and Stock Appreciation Rights Received by Nonresidents and Part-Year Residents,* TSB-M-06(07)I (Oct. 12, 2006) [hereinafter *2006 Memorandum*).

[100] *See e.g.,* David W. Bunning & Marvin A. Kirsner, Greenberg Traurig, LLP, Alert: Tax, *Refunds of New York State Income Tax May Be Available Following Tax Appeals Tribunal Decision and Tax Department Guidance Regarding the Exercise of Stock Options By Non-Residents* 2, *available at* www.gtlaw.com/pub/alerts/2006/1100e.pdf.

[101] *2006 Memorandum, supra* note 99, at 2. Several months after the issuance of the 2006 Memorandum (at the time of publication of this article), it appears to state and local tax practitioners that the Department is attempting to limit the holding in *Stuckless II* (adoption of the year-of-exercise methodology) to situations that involve option income realized prior to termination or retirement. If a taxpayer exercises options after termination or retirement, the Department may not accept the year-of-exercise methodology as a fair and adequate means of determining option income allocable to New York. Therefore, for open tax years prior to 2006, practitioners' initial concerns over the language set forth in the 2006 Memorandum, in particular the italicized portion cited above, were well founded. As two practitioners recently observed, the Department is currently employing for post-termination and retirement cases a variety of methodologies to determine the portion of stock option income that should be allocated to New York, including days worked during the final year of employment, a three-year look back period and the grant to exercise methodology expressly rejected by the Tribunal in *Stuckless II. See* Timothy P. Noonan & Jack Trachtenberg, *Stock Options - The New York Tax Department's Effort to Undermine Stuckless*, 44 St. Tax Notes (TA)4 (Apr. 23, 2007).

[102] Reg. §1.861-4(b)92)(ii)(F)

[103] Reg. §1.861-4(b)(2)(ii)(F) (emphasis added).

[104] *Assessment of Public Comment*, *supra* note 90, at 4.

[105] Note, however that in the case of a nonresident alien, New York income starts with federal adjusted gross income. N.Y. Tax Law §631 (McKinney 2006).

[106] *See, e.g.,* P.L.R. 1990-37-008 (May 29, 1990); P.L.R. 1987-11-107 (Dec. 17, 1986).

[107] Press Release, *OECD, OECD Publishes a New Updated Version of its Model Tax Convention,* July 9, 2005), *available at* www.oecd.org/document/11/0,02340,en_2649_201185_3518475_1_1_1_1,OD.html; OECD Commentary on the Articles of the Model Tax Convention, Art. 15, §12.14, *reprinted in* RIA Int. Tax Treaty 4837; *see also* OECD, The 2005 Update to the Model Tax Convention, Mar. 15, 2004 (discussing revisions to the commentary of Article 15); OECD, Centre For Tax Policy and Administration, Cross-Border Income Tax Issues Arising From Employee Stock Option Plans, at 14-16 (2004.

[108] OECD, Centre for Tax Policy and Administration, Cross-Border Income Tax Issues Arising from Employee Stock Option Plans, at 15 (2004) (citing OECD, Commentary on the Articles of the Model Tax Convention Art. 15, §12.14).

[109] *See* Pricewaterhouse Coopers, IAS Global Watch Service, *Tax Authorities Provide New Comments on Article 15 of the OECD Model Tax Treaty*, July 25, 2005; *available at* http://www.pwcservices.com/PwC_Serv/IAS/IASMARKETING.NSF/10086696c9bcd74585256ab2006f7162/9080db6cfea89ada852570 49006c3dbc?OpenElement (discussing the new comments issued by the Belgian Tax Authorities on cross border income taxation of compensation income).

[110] N.Y. Comp. Codes R. & Regs. tit. 20, §132.18(a) (2006). For example, if an employee works from his home in State A two days a week, and from his employers office in State B three days a week, this employee would have 40% of his income sourced to State A and 60% of his income sourced to State B, assuming both State A and State B both employ this test.

[111] N.Y. Tax Law §687(a)(McKinney 2006).

[112] N.Y. Tax Law §671 (McKinney 2006).

[113] *See generally* Cal. Rev. & Tax Code §17951 (West 2006); California Franchise Tax Board Stock Option Guidelines, F.T.B. Publication 1004 (2002) , at p. 3-4 (discussing California's date of grant to exercise allocation methodology); *see also* Conn. Agencies Regs. §12-711(b)-18 (2006)) imposing date of grant to exercise allocation methodology for nonqualified stock options); Conn. Agencies Regs. § 12-711(b) – 16 (2006) (imposing date of grant to exercise allocation methodology for incentive stock options).

[114] *See supra* note 113 (explaining Connecticut's use of a date of grant to exercise methodology, rather than New York's new date of grant to vesting allocation methodology).