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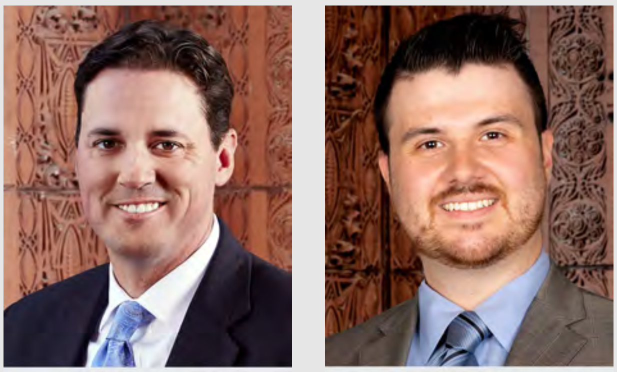

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In this installment of Noonan's Notes, Noonan and Tantillo outline the history of stock-based compensation taxation in New York, summarize the current legal landscape, and outline how the rules work through some examples and other analysis.

For decades, employers have used creative compensation structures to attract and retain employees, with stock-based compensation as a primary method, especially for top executives. The idea is simple and logical: By tying an employee's compensation to how well the company does, the employee is incentivized to act in its best interests, to "act like an owner," and to work hard to increase the company's value. And if the stock price goes up, everybody wins.

In turn, tax professionals like us have grappled with how stock-based compensation is supposed to be taxed,[1] with state taxes presenting a distinct and complex challenge. This is particularly the case for nonresident taxation, with states trying to figure out how to tax income that is received in one year but arguably earned over the course of many others. In our practice, we've been dealing with the application of New York's rules for decades, we're litigating in Connecticut on a stock option issue,[2] and we've consulted on the state taxation of options in many other states — including California, New Jersey, and elsewhere.[3]

However, the New York history is especially captivating and illuminating, with the case law essentially creating the roadmap to the state's current law and policy for taxing nonresidents on stock options and other stock-based compensation. In this article, we'll outline that history, summarize the current legal landscape, and outline how the rules work through some examples and other analysis.

A New York History: From *Michaelsen* to *Stuckless* and Beyond

As a starting point, most states — including New York — will look to federal rules, at least to determine the extent of the compensation. For federal income tax purposes, an employee who receives a nonqualified stock option or restricted stock unit is generally not subject to federal

[1] Well, Tim has grappled with this issue for decades. Joe has been wishing for lots of income from stock options for decades, but has only been thinking about the tax implications for a year or so.

[2] *Costas v. Sullivan*, 2020 WL 1698705, HHB-CV17-6036725-S (Conn. Superior Ct. 2020), *appeal pending*, AC 44075 (docketed March 30, 2020).

[3] We addressed the multistate issue in considerable detail previously; *see* Timothy Noonan and Paul Comeau, "Multistate Taxation of Stock Option Income — Time for a National Solution?" *State Tax Notes*, June 30, 2008, p. 1063.

income tax when the option is granted. The gain attributable to the difference between the option price (which is often the stock's fair market value at the time of grant) and the FMV of the stock on exercise, however, will be treated as taxable compensation. When the stock is sold, any post-exercise appreciation is taxed as capital gain. In *Matter of Michaelsen*,[4] the New York Court of Appeals confirmed that New York nonresidents who receive stock option income from New York employment are subject to state personal income tax on the portion of the gain representing the difference between the option price and the FMV of the stock when the option is exercised. Further, if at the time of the sale the value of the stock has increased since the exercise of the option, the appreciation would be treated as investment income and would not be taxable to a nonresident.

Following the *Michaelsen* ruling, many open questions remained. Most notably, while *Michaelsen* confirmed how much of an employee's income would be taxed as compensation generally, the case did not address how a nonresident employee would allocate this income to New York — especially when they worked inside and outside the state during the grant-to-exercise period. But in response to that case, the New York State Department of Taxation and Finance didn't change its laws or regulations to reflect the decision. Instead, it only issued a Technical Services Bureau Memorandum (called a TSB-M), with guidance explaining its view of how the existing law is applied when an employee performs services both within and without New York.[5]

In this 1995 TSB-M, the department explained that stock option compensation received by the employee during the compensable period — the grant-to-exercise period identified by the *Michaelsen* court — was to be allocated to New York based on the employee's workdays over that grant-to-exercise period. More specifically, it was to be computed by multiplying the compensation attributable to the stock option by a fraction: the numerator being the total days worked by the employee inside New York during the period, and the denominator being the total days worked by the employee everywhere during that period. And for employees who exercised an option following the termination of their employment with the employer who granted that option, the TSB-M limited the allocation to the period from the date of grant to the date of termination.

The TSB-M also outlined similar sets of rules for other forms of stock-based compensation (such as restricted stock units and stock appreciation rights) following a similar theme, which is that the compensation element of the stock-based income of a nonresident is allocated to New York based on the days worked in and out of New York over the compensable grant-to-exercise or (in the case of restricted stock units) grant-to-vest period.

A few years later, we litigated the *Rawl* case, in which our firm took on the TSB-M and its rationale head-on.[6] In that case, stock options were granted to then-Exxon CEO Lawrence Rawl in the mid-1980s, when Exxon was headquartered in New York. Rawl, a nonresident of New York, worked inside and outside the state during his time as CEO, but in 1991, the year he exercised the options, Exxon had moved its headquarters to Texas and Rawl worked zero days in New York. So because the options generated income to him in 1991, and because he didn't work in New York that year, he did not allocate any of the income from the exercise of the stock options to New York.

Citing the 1995 TSB-M, the department stated that the taxpayer's allocation percentage should have been based on his total workdays during the grant-to-exercise period, and an appeal ensued. On appeal, an administrative law judge in the Division of Tax Appeals rejected the department's approach, holding instead that the only allowable method in place in 1991 for the allocation of stock option income was based on workdays in the year of receipt. In support of that, the ALJ pointed to prior external and internal guidance that the taxpayer forced the department to produce, as well as numerous older cases indicating the agency's prior position that the income from stock

[4]*Michaelsen v. New York State Tax Commission*, 67 N.Y.2d 579 (1986).

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

[6]*Matter of Lawrence G. Rawl*, DTA No. 813892, ALJ (Dec. 10, 1998).

options was to be allocated based on year-of-receipt factors.[7] Given this history, and the fact that the TSB-M was issued some four years after the taxpayer exercised his stock options, the ALJ canceled the assessment and found that the TSB-M constituted a reversal of department policy without prior public notice, and thus could not be applied retroactively to the 1991 tax year. But because the taxpayer successfully knocked out the assessment on retroactivity grounds, the ALJ stopped short of addressing the taxpayer's other argument, which was that the department could not legislate new allocation methods through guidance documents like TSB-Ms. That fight would have to wait a few more years.

Enter the *Stuckless* case.[8] In 1991 and 1992 E. Randall Stuckless was granted incentive stock options by his employer and, when the options were granted, he was a New York resident. But Stuckless moved to Seattle in 1996, where he lived until he moved back to New York in 1998. While residing in Seattle, he performed no work in New York. More importantly, while he was in Seattle in 1997 and 1998, he exercised a bunch of stock options and paid no New York tax on the basis that he did not work in New York in the years of receipt. Citing the 1995 TSB-M, the department employed the grant-to-exercise rule and issued him a large assessment, owing to his work in New York between 1991 and 1997. In appealing the assessment, the taxpayer argued that no tax should be due because he didn't work at all in New York during the years of exercise. Plus, he pointed out that most of the increase in the value of his stock options came after he left New York. He argued that New York could not tax any of his option income and that it was barred from taxing any gain realized as a result of the increase in the stock's value after he left New York.

In *Matter of Stuckless I*, the tribunal went along with the latter approach, holding that the stock value increase when he lived and worked in Washington could not be attributable to his employment in New York. Thus, rather than focus on workdays in New York over the grant-to-exercise period, the tribunal held that the department could not consider any post-New York appreciation when determining the amount of stock option income subject to New York tax.

The decision sent shockwaves through both the local New York tax community[9] and the department — so much so that it asked the tribunal to revisit its decision through a motion for reconsideration, a procedural step that is often just a fool's errand. But in a peculiar twist, after its makeup shifted a bit in the interim, the newly constituted tribunal quite shockingly granted the department's request to reconsider its own decision.[10]

Unfortunately for the department, the taxpayer still prevailed in the sequel, *Stuckless II*.[11] But the tribunal got there a different way. First, it agreed with the department that the appreciation method the tribunal used in *Stuckless I* was not consistent with New York's law and regulatory framework, so that method was rejected.[12] Rather, the core holding of *Stuckless II* was that stock option income received by a nonresident must generally be allocated to New York based on the taxpayer's workday factors during the year of exercise. The tribunal also rejected the 1995 TSB-M outright, holding that it was inconsistent with existing laws and regulations, and it chastised the department for trying to issue an allocation rule of general applicability without adopting a regulation in accordance with the requirements of New York's State Administrative Procedure Act. Ultimately, the tribunal held that the year-of-exercise rule was the only appropriate rule for allocating stock option income under existing New York law.

Following *Stuckless II*, however, the New York State Legislature and the department took swift

[7] *Id.*

[8] *Matter of E. Randall Stuckless*, DTA No. 819319, Tax Appeals Tribunal (May 12, 2005).

[9] Or at least a couple young tax attorneys thought it was noteworthy: Noonan and Jack Trachtenberg, "*Matter of E. Randall Stuckless and Jennifer Olsen*: New York Tax Appeals Tribunal Issues Stock-Option Decision," *State Tax Notes*, July 4, 2005, p. 95.

[10] Tax Appeals Tribunal (Dec. 15, 2005).

[11] *Matter of E. Randall Stuckless*, DTA No. 819319, Tax Appeals Tribunal (Aug. 17, 2006).

[12] Interestingly, in other states this kind of appreciation method has been sanctioned as a possible method for the allocation of stock option income. In *Matter of Prince*, OTA Case No. 19024304 (Cal. Off. Tax App. 2021), the California Office of Tax Appeals rejected a nonresident taxpayer's proposal to base his allocation on the appreciation of his Facebook stock after he left California. However, the agency did explain that if evidence existed to show that the taxpayer's services had a disproportionate impact on the share price, the use of a stock appreciation method like this would be permissible.

action. If the problem with New York's prior rules on stock options was that their position wasn't outlined in any law or regulation, the solution was simple: Pass laws and regulations that outlined the rules.

The Post-*Stuckless* Rules: Grant-to-Vest Allocation Periods

Beginning with the 2006 tax year, New York's laws and regulations were amended to specify how nonresidents would be required to allocate their stock-based compensation.[13] The provisions outlined new allocation rules for statutory (or qualified) stock options, nonqualified stock options, stock appreciation rights, and restricted stock units — and for the most part employed a grant-to-vest concept, different than what had been proscribed in the 1995 TSB-M.

Nonqualified Stock Options

In practice, we typically see so-called nonstatutory or nonqualified stock options. Under the 2006 rules, if a nonstatutory stock option has a readily ascertainable FMV at the time of grant, the amount of compensation is the difference between the FMV of the option on the date that the option is granted and the amount the individual paid for the option. That compensation is then allocated to New York by a nonresident based on the number of days worked in the state during the grant year.

This, however, is less common. In most cases, the option does not have a readily ascertainable FMV at grant, and the amount of compensation is based on the difference between the FMV of the stock at the date of exercise and the FMV of the stock at the date of grant. And for nonresident allocation purposes, the New York-source portion of this income is determined based on the number of days worked in the state between the date of grant and the date of vesting. Again, this is a departure from the grant-to-exercise rule that was outlined in the 1995 TSB-M.

Statutory Stock Options

While the compensation element of a nonqualified stock option is calculated at the date of exercise, income from statutory stock options or incentive stock options (ISOs) for both federal and New York income tax purposes is not recognized until the date the stock is sold. But the allocation rules for these types of options are similar, in that the New York-source portion of the compensation is determined based on the number of days worked in the state during the grant-to-vest period.[14]

Restricted Stock Units

Restricted stock units are generally taxable for federal purposes as ordinary income in the year of vesting.[15] There is no separate "exercise" event for tax purposes. However, if the taxpayer makes an election under IRC section 83(b), the taxation and allocation rules vary. In that case, the value of the stock is included in taxable income (recognized) in the year the stock is received — that is, in the year of grant.

Thus, if an 83(b) election is made, the compensation amount is the difference between the FMV of the stock on the date that it was received and the amount paid for the stock by the individual. The New York-source portion of this amount is determined based on the number of days worked in the state during the grant year.

If an 83(b) election is not made, the taxable amount of compensation is equal to the difference between the amount paid (if any) and the FMV on the earliest date that the stock is substantially vested.[16] The amount taxable as ordinary income for federal purposes can represent taxable compensation to a nonresident for state income tax purposes. And here again, we follow the same grant-to-vest rule, with the amount of New York-source income based on the number of days worked in New York during the grant-to-vest period.

[13] *See* N.Y. Tax Law section 631(g), 638(c); TSB-M-07(7)I.

[14] N.Y. Comp. Codes R. & Regs. tit. 20, section 132.24(c)(2).

[15] N.Y. Comp. Codes R. & Regs. tit. 20, section 132.4(c)(3)(iii).

[16] *Id*.

Examples

Example 1

Facts. On January 1, 2016, TechCo granted Martha nonstatutory stock options. The options did not have a readily ascertainable FMV on the date of grant. The stock options allowed Martha to purchase 10,000 shares of TechCo's stock for $5 per share, and were fully vested on January 1, 2019, three years from the grant date. Martha, who lives in Florida, worked a total of 720 days for the company from 2016 to 2018, 500 of which were in New York. In 2019 her office was relocated to Florida, and she didn't work in New York after that. On January 1, 2021, she exercised all 10,000 shares of TechCo, and the stock was worth $100 on that day.

Analysis. Martha recognizes taxable compensation of $95 per share upon exercise (the difference between the grant price and the exercise price), so at 10,000 shares, that's $950,000 in total compensation. That's the good news. The bad news? Although she hasn't worked in New York for a couple years, Martha's option income is still taxed there based on the number of days worked in New York between the date of grant and the date of vest. And since 69.4 percent of her workdays over that period were in New York (500/720 days), about $660,000 of this compensation would be treated as New York-source income.

Example 2

Facts. Same facts as Example 1, but in this example, Martha was a New York resident from 2016 to 2019 and didn't move to Florida until the middle of 2019.

Analysis. The answer is the same: As long as Martha is a nonresident when she exercises the options and triggers taxable income, she is entitled to allocate the income based on her days worked in New York during the grant-to-exercise period. New York's accrual rule — which requires a taxpayer who changes resident status to accrue any income that is fixed and determinable in the year of the residency change — would also not apply here, because the amount of stock option income was not fixed when she moved in 2019. The total amount of income would necessarily vary based on TechCo's stock price.

Example 3

Facts. Same facts as Example 1, but here Martha received ISOs from TechCo. She exercised the ISOs on January 1, 2021, but didn't sell the stock until January 1, 2023, when the share price ballooned to $200 per share.

Analysis. For New York tax purposes, the same amount of tax is going to be paid: Martha will allocate the compensation element of the ISO based on the number of days worked in New York between the date of grant and vest. But as an ISO, she doesn't pay tax until 2023, when she sells the stock. And at that point, while $950,000 is treated as taxable compensation, the remaining $100 difference between the exercise price and the sale price is treated as capital gain income, not taxable to Martha in New York because she is not a New York resident. So with 10,000 shares, Martha reports another $1 million in capital gain income.

Example 4

Facts. Liam lives in New Jersey but works across the river at TechCo's office in New York City. On January 1, 2020, TechCo awarded 10,000 units of restricted stock at a price of $5 per share, with the stock trading at $50 per share. Liam did not make a section 83(b) election at that time. The entire stock award vests two years later, on January 1, 2022, with the stock trading at $100 per share. For the first three months of 2020, Liam worked in New York, but once COVID-19 hit he worked from home in New Jersey for the rest of the year. So for 2020, he worked about 60 days in New York out of 240 total workdays for the year. On January 1, 2021, he moved to Florida and started work in TechCo's Miami office, although he still came up to New York to work on 24 days out of 240 total workdays in 2021.

Analysis. Liam will report $950,000 in taxable compensation in 2022 as a result of the vesting of the restricted stock. And like Martha, he'll still have to look back at prior-year workdays — when he was working more in New York — to determine the New York-source portion of his compensation. Moreover, he's likely to get tied up with New York's convenience-of-the-employer rule for his 2020 workdays. Under that rule, any days he worked at home in New Jersey will be treated as New York workdays unless he was working in New Jersey for the necessity of his employer.[17] Although his 2020 days worked at home were arguably not for his own convenience — we were in a pandemic, after all — New York's position thus far has been to treat days like this as New York workdays. The jury is still out on whether that position will be upheld!

Thus, all his 240 workdays in 2020 will be treated as New York workdays. For 2021, only 24 of his 240 workdays were in New York, so his total workday fraction would be 264/480, or 55 percent. Therefore, 55 percent of his $950,000 in restricted stock compensation (or about $520,000) will be subject to tax in New York. Any increase in the stock price after the 2022 vesting is taxed as capital gain income when Liam sells the stock, and as a Florida resident would not be taxed in New York when sold.

Example 5

Facts. Same as Example 4, but in this example, Liam makes an 83(b) election in 2020.

Analysis. The section 83(b) election has an impact on Liam's New York tax bill. The effect of the election is to create taxable compensation in 2020, the year the stock award was made, based on the difference between the price Liam paid for the stock ($5) and the FMV of the stock on the date received ($50). So that $45-per-share ($450,000) total is taxed as compensation for federal and New York purposes in 2020. And because Liam worked 100 percent of the time in New York in 2020 (at least based on New York's application of the convenience rule), the full amount would be subject to tax in New York. Any increase in the value of TechCo's stock, however, would be taxed to Liam as capital gain income for federal and New York purposes, so that appreciation would not be taxed in New York.

Other Nuts-and-Bolts Consideration: Tracking Workdays

Since the location of workdays is so important to the final allocation of stock option compensation income, the need to count your days is critical. But how do you count your days, particularly when dealing with options that may vest over multiyear periods? Your best tool is your cellphone. Like it or not, our mobile phones are tracking us constantly. Every call can be used to pinpoint your physical location on a given day. And there are plenty of apps out there that were invented for the very purpose of tracking your location for tax planning reasons. But physical location is only half the battle.

The allocation periods above are concerned with *workdays*. What actually counts as a workday? The term "workday" is not limited to full days spent working in an office. And while a single phone call may not be enough to classify a day as a workday, a series of calls or a lengthy conference call might suffice. Typically, there is a presumption that weekends and holidays are treated as non-workdays, but a taxpayer can overcome that presumption if she has the proof to show she did enough work to qualify the day as a workday. And days — or even partial days — spent traveling at the direction of your employer are considered working days, even if they fall on a holiday or weekend. In the new remote work era, people are working more than ever, and you can have situations in which an individual actually works 300 days per year.

Retroactively proving a workday can be difficult, but if you understand the rules, then you can prepare yourself by keeping records along the way. Physical location is the first step, and as we learned earlier, where you work is pivotal to your allocation computation. But once you've determined location, how do you show that you worked or didn't work? Office swipe records — if your employer uses them — can be excellent proof that you worked, because it is generally assumed that people physically go into their office to conduct business, especially in the remote work era. Email can also substantiate a workday. But the best tool is often your own personal calendar. Whether you use a digital calendar or an old-school paper one, keeping a detailed record of your workdays and non-workdays will prove extremely useful if you are required to provide records of how you computed your New York-source income. ■

[17] For a broader discussion of the convenience rule over the course of the pandemic, see Noonan and Emma Savino, "New York's Convenience Rule: Under the COVID Microscope," *Tax Notes State*, May 31, 2021, p. 893.