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Stock Options -- the New York Tax Department's Effort to Undermine Stuckless

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Over the past couple years, *Stuckless* has been kicking around New York's Division of Tax Appeals and creating lots of uncertainty for tax practitioners and taxpayers in the stock option area. And unless you've been hiding under a rock for the past six months, you've probably also heard about the tribunal's momentous decision in *Matter of E. Randall Stuckless*[1] -- in which it overturned its own previous decision.[2] That decision, a clear victory for taxpayers and practitioners who have been grappling with the Department of Taxation and Finance on the issue for the last decade, was supposed to end the debate on the stock option issue once and for all. Indeed, New York's long-standing policy of taxing a nonresident's stock option based on a multiyear "grant-to-exercise" workday allocation was disposed of in favor of a simple and straightforward "year-of-exercise" rule. In short, under the tribunal's decision, a nonresident taxpayer pays New York tax only to the extent he or she worked in New York during the year the stock options were exercised.

Easy, right?

Much to the chagrin of taxpayers and their representatives, implementation of those new rules has been anything but easy. Instead, based on our recent experiences with auditors and discussions with tax department personnel, it appears that the department is, in fact, seeking to avoid the application of *Stuckless* in many situations, and in particular when options were exercised after a taxpayer had retired or otherwise terminated employment. In a technical bulletin (TSB-M-06(7)I) issued quickly after *Stuckless* was decided, the department seemed to assert that the year-of-exercise rule should not be used when options are exercised posttermination because it does not result in a "fair and equitable" allocation of income. That new TSB-M suggests it may be necessary in those cases to use an alternative allocation method, such as the same multiyear grant-to-exercise rule deemed invalid by the tribunal in *Stuckless*!

So unfortunately, rather than ending the debate, the department's response to *Stuckless* just creates a new issue to fight over. But we think that is a fight taxpayers can win. In this article, we'll discuss this important decision in detail and address the department's recent attempts to limit its scope.

Background on *Stuckless*

E. Randall Stuckless was granted incentive stock options by his employer, Microsoft Corp., in 1991 and 1992. When the options were granted, Stuckless was a resident of, and worked in, New York state. The options were granted under Microsoft's stock option plan, which provided that those options were granted to "attract and retain the best available personnel."

In September 1996 Stuckless moved to Seattle. He resided in Washington state until he moved back to New York in July 1998. During that period, Stuckless continued to work for Microsoft. He was a nonresident of New York and performed no work there. When he moved back to New York in July 1998, he became a resident of the state and continued to work for Microsoft.

Stuckless exercised and sold a portion of his options in 1997 and 1998 -- while he was a resident of Washington -- and did not report any of that option income to New York state. Following an audit, the tax department issued an assessment that allocated to New York the gain he recognized on exercise based on the number of Stuckless's New York working days during the grant-to-exercise period as compared with the total number of days worked both within and outside New York for the same period. That was the method set forth by the department in a 1995 technical bulletin (TSB-M-95(3)I). It was not part of any New York law or regulation.

Under the department's calculations, it applied Stuckless's grant-to-exercise workday allocation (around 70 percent) to the total gain recognized by him as a result of the option exercise, that is, the difference between the option price and fair

market value of the option on the date of exercise. But Stuckless did not think New York could subject all of that option income to tax. Obviously, the nature of stock option income is such that the options become more valuable as the company's stock price increases. Stuckless was able to show that most of the appreciation in his Microsoft stock occurred after he left New York, that is, after September 1996. Thus, in addition to arguing that New York could not tax *any* of his option income, Stuckless also argued that the department was prohibited from taxing any gain realized as a result of the increase in the value of Microsoft stock after he stopped working in New York.

First Tribunal Decision

Initially, the tribunal held that the increase in the value of the stock during the period in which Stuckless lived and worked in Washington was not attributable to his employment in New York. Consequently, the fair market value of the stock on the date that Stuckless moved out of New York had to be used in determining the gain realized for New York state income tax purposes. The tribunal said the department could not take into account any post-New York appreciation when determining the amount of stock option income subject to New York tax.

That decision came as a shock to the department, so much so that it asked the tribunal to reconsider its decision. Even more shocking, however, was the tribunal's decision to grant the department's request, reopen the case, and basically take another shot at getting to a final decision on the issue.[3]

Second Tribunal Decision

But ultimately, the tribunal's second decision was no better for the department, and arguably results in an even more taxpayer-friendly regime for the taxation of stock-option income. As noted above, the core holding of the second *Stuckless* decision is 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. That determination was based on the tribunal's reading of 20 NYCRR sections 132.18(a) and (b), which set forth the "default" rules applicable to employees performing services partly within New York. Regarding those provisions, the tribunal said: "The rules and examples set out in section 132.18 of the regulations express, or strongly imply, an allocation based on work days within the taxable year in which the income is realized."

The tribunal noted, however, that the rules in section 132.18 are subject to the flexibility afforded by two other rules: 20 NYCRR sections 132.4(c) and 132.24. Respectively, those regulatory provisions assert that (1) compensation for personal services performed in New York will retain its New York source even if the compensation is paid in a taxable year after that in which the services were performed; and (2) an alternative allocation method may be used or required when the general rules of section 132.18 do not apply in a fair and equitable manner. Though the tribunal recognized that sections 132.4(c) and 132.24 "temper" the rigor of the general year-of-exercise rule, it determined that neither provision applied in *Stuckless*.

The tribunal held that section 132.4(c) does not permit *any* multiyear allocation period to be used for stock options. Consequently, the tribunal rejected TSB-M-95(3)I and its grant-to-exercise rule as being inconsistent with the regulations. The department tried to argue that section 132.4(c) permits the use of a multiyear lookback period because, under *Michaelsen v. New York State Tax Commission*,[4] stock option income represents compensation (as opposed to investment income) to the extent of the difference between the value of the option at the time of its exercise and the value of the option at the time of its granting. The tribunal agreed that *Michaelsen* used the grant-to-exercise period to calculate the *amount* of compensation derived from an option, but disagreed that *Michaelsen* required the same period be used for purposes of determining *how* the total amount of compensation should be allocated to New York. Rather, the tribunal determined that section 132.4(c) prohibits a multiyear allocation period for stock option income.

The tribunal also held that the department could not justify its issuance of TSB-M-95(3)I under section 132.24 of the regulations. Under section 132.24, the department could adopt alternative methods of allocation when application of the general allocation rules did not allocate a nonresident's income in a fair and equitable manner. The department argued that it was authorized under section 132.24 to require the taxpayer to use the grant-to-exercise rule of TSB-M-95(3)I because it would be unfair and inequitable to allocate the options in *Stuckless* based on the taxpayer's workdays only in the year of exercise (presumably because it would result in zero tax due, even though the taxpayer worked in New York during a portion of the period in which the options were increasing in value).

The tribunal rejected the department's reading of section 132.24. According to the tribunal, section 132.24 was designed to accommodate only ad hoc situations in which application of the general allocation rules would lead to unfair results. According to the tribunal, TSB-M-95(3)I is "clearly not such a special tailoring of allocation and apportionment to the

peculiar circumstances of [the taxpayer]." Rather, it represented "a highly articulated set of rules of general application" that instructed all nonresidents to use the grant-to-exercise method when allocating stock-option income. The tribunal held that the department could not do that under the auspices of section 132.24 because doing so would allow the department to enforce a rule of general applicability (in a manner that was equivalent to the adoption of a regulation) without actually having to adopt a regulation in accordance with the promulgation requirements of New York's State Administrative Procedure Act (SAPA).

Accordingly, the tribunal held that, because Stuckless did not work any days in New York during the year of his option exercises, none of his income was subject to New York tax. The "year-of-exercise" rule, according to the tribunal, was the only appropriate rule under existing New York law.

Life After *Stuckless*

Following *Stuckless*, the department promulgated new regulations applicable to tax years beginning on or after January 1, 2006. Generally, the new regulations require nonresident taxpayers to allocate stock option income based on their workday factors during the period between the date on which the options were granted and the date on which the options vested.[5] For the 2006 tax year, the regulations also allow taxpayers to use the old "grant-to-exercise" approach set forth in the 1995 TSB-M. Because those new regulations were not promulgated until late 2006, there is a question about whether they can apply retroactively to taxpayers who exercised options earlier in 2006. But that is a topic for another monthly edition of Noonan's Notes on Tax Practice!

Of more interest, however, is that for tax years before 2006, the department seems to be taking steps to undermine the core holding of *Stuckless*, which is that a nonresident taxpayer pays New York tax only to the extent he or she worked in New York during the year the stock options were exercised.

Application to Posttermination Option Exercises

It was thought that the tribunal finally ended the stock option debate by issuing its second decision in *Stuckless* and making "year-of-exercise" the rule going forward. But the department's position seems to be that it is not required to follow *Stuckless* when the taxpayer exercised options after retirement or termination. Rather, it appears that the department may be trying to allocate posttermination option exercises based on one of several different tests. Some auditors suggest using the workday factors for the taxpayer's last year of work; others suggest a three-year lookback; and still others are requiring the use of the taxpayer's workday factors over the grant-to-exercise period -- the same rule that was invalidated in the *Stuckless* decision.

The department's position is not at all consistent with *Stuckless* and appears to fly in the face of rationale employed by the tribunal in coming to its decision.

If the tribunal in *Stuckless* made one thing perfectly clear, it is that section 132.4(c) does not authorize the department to require taxpayers to use multiyear allocation periods for stock option income.[6] On that holding alone, the department's apparent position regarding posttermination option exercises is invalid and in contravention of the tribunal's decision. The grant-to-exercise rule that the department may be seeking to impose on posttermination exercises constitutes a prohibited multiyear allocation period. Certainly, section 132.4(c) may permit a "look back" to a single prior year in the context of some deferred compensation (for example, an annual bonus). But under *Stuckless*, the department cannot use section 132.4(c) to look back to even one prior year when allocating stock-option income. Rather, the tribunal held that in the absence of an option-specific regulation, stock options must be allocated based on the default year-of-exercise rule in section 132.18.

Stuckless was also unambiguous in holding that section 132.24 (allowing the department to use alternative allocation methods) can be used only in ad hoc situations. The tribunal explained the ad hoc requirement as meaning that the alternative method employed must represent a "*special tailoring* of allocation . . . to the *peculiar circumstances* of [the taxpayer]." Section 132.24 cannot be used to enforce a generally applicable rule to an entire class of taxpayers. It is difficult, therefore, to find support for the department's position regarding posttermination exercises. The use of section 132.24 (now renumbered as 20 NYCRR section 132.25) to require *all* posttermination exercises to be allocated based on the grant-to-exercise rule does not seem to represent the sort of "special tailoring" to the "peculiar circumstances" of a particular individual the tribunal envisioned when discussing section 132.24 in *Stuckless*. Rather, it once again represents an invalid attempt by the department to apply a rule of general applicability to an entire class of taxpayers.

Moreover, it is worth noting that an alternative allocation method may be required only if application of the general allocation rules would lead to unfair results. In *Stuckless*, the tribunal required an allocation of the taxpayer's options based on the general year-of-exercise rule. For most of the options in question, that resulted in zero tax being due, even though the taxpayer had worked in New York during some prior year after the options had been granted. Was that fair? It doesn't seem so.

Consequently, we can take from *Stuckless* that the general allocation rules will not be deemed to lead to "unfair or inequitable" results simply because their application will allow a taxpayer with prior New York services to avoid paying any tax. In the same way, a taxpayer who never works in New York but exercises stock options after changing residence to New York is subject to full tax on the option income (because residents are taxed on all their income). That isn't fair and equitable either -- but it is the way the law works. It is difficult to see, therefore, the department's basis for requiring posttermination exercises to be allocated based on an alternative method. To do so, the department would have to assert another reason (other than citing to prior New York workdays) why use of the year-of-exercise rule is unfair or inequitable.

Conclusion

So while the tribunal's second decision in *Stuckless* quieted one debate, it has started a new one. And on the new issue, the department's position is once again questionable and subject to challenge. Taxpayers who have exercised options posttermination are on strong legal footing to demand an allocation based on the year-of-exercise rule. Taxpayers finding themselves under audit and facing this issue should consider contesting any assessment based on an alternative allocation method, such as the grant-to-exercise rule. And taxpayers who have already filed income tax returns with New York for tax years before 2006 should consider filing refund claims if they exercised options in a posttermination year and allocated the option income on their return using the grant-to-exercise method. Based on the department's current view of the law, it is likely that the department will reject such refund claims; however, by filing a refund claim before the statute of limitations for doing so expires, taxpayers can preserve their rights to administratively protest any adverse decision of the department.

Other options available include the possible filing of an Article 78 or declaratory judgment action in New York State Supreme Court seeking an order that requires the department to comply with *Stuckless*. Typically, taxpayers are required to exhaust their administrative remedies before seeking judicial relief in state court. The nature of the issues discussed in this article, however, makes the department susceptible to an immediate judicial challenge. Given the appropriate case, a state court action could expedite the decisionmaking process by avoiding the lengthy administrative protest and appeals process that is typically required of taxpayers who disagree with the department's actions.

So stay tuned. More cases on New York stock option issues are destined to follow.

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FOOTNOTES

[1] Tax Appeals Tribunal (Aug. 17, 2006). (For the decision, see *Doc 2006-16137* [PDF] or *2006 STT 167-15*.)

[2] Tax Appeals Tribunal (May 12, 2005). The tribunal's previous decision in *Stuckless* was reported on by the authors in a previous *State Tax Notes* article. For the article, see State Tax Notes, July 4, 2005, p. 95, *2005 STT 127-25*, or *Doc 2005-11908* [PDF].

[3] Tax Appeals Tribunal (Dec. 15, 2005). (For the decision, see *Doc 2005-12404* [PDF] or *2005 STT 110-19*.)

[4] 67 N.Y.2d 579 (1986).

[5] *See* 20 NYCRR sections 132.24 and 132.25.

[6] That said, as the department makes clear in TSB-M-06(7)I, taxpayers could continue to be allowed the use of the grant-to-exercise method set forth in TSB-M-95(3)I in some situations. And indeed, some taxpayers might prefer the old approach given their specific factual situations. Nothing in *Stuckless* appears to prohibit the department from allowing the use of the old allocation rules when requested by the taxpayer.