# NEW YORK STATE BAR ASSOCIATION

# TAX SECTION

# REPORT ON PROPOSED REGULATIONS UNDER TAX LAW SECTIONS 631(g) AND 638(c) (STOCK OPTIONS, STOCK APPRECIATION RIGHTS AND RESTRICTED STOCK)

# SEPTEMBER 20, 2006

**Report No. 1117**

**New York State Bar Association Tax Section**
**Report on Proposed Regulations under Tax Law Sections 631(g) and 638(c)**
**(Stock Options, Stock Appreciation Rights and Restricted Stock)**[1]

## I. Background

In our April 20, 2005 Tax Section Report on New York's nonresident income allocation[2] we noted that New York nonresident and part-year resident income allocation rules were sometimes ambiguous. We further noted that the primary cause of the ambiguity was the "absence of Regulations that fully develop the relevant issues and reflect case law holdings regarding the taxability of various categories of income."

The Tax Section Report noted specifically that there was substantial confusion with respect to the allocation of the compensable portion of a nonresident employee's stock option income if the employee performed service both within and outside of New York. There are several time periods that have been or could be considered for use in allocating income obtained through the exercise of stock options when a nonresident employee performs services both within and outside of New York. For example, for similar federal tax purposes, an allocation is made in respect of the applicable vesting period, thus aligning the allocation with the services required to qualify for the compensation.[3]

At the time of the report, the Department of Taxation and Finance took the position that the nonresident was required to allocate the compensable component of the

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[1] The principal author of this report was Robert E. Brown. Helpful comments were received from Kimberly S. Blanchard, Paul R. Comeau, Peter L. Faber, Tali Harel, Carolyn Joy Lee, Andrew Oringer, Michael Schler and Jack Trachtenberg.
[2] Report No. 1084.
[3] Treas. Reg. Section 1.861-4(b).

stock option[4] based on a fraction the numerator of which is the total days worked by the employee in New York during the period from grant of the option to the date of its exercise and the denominator of which is the total number of days worked by the employee inside and outside the state during the same period. The Department's position was articulated in a Technical Service Bureau Memorandum[5] and its nonresident audit guidelines.[6] We noted that the grant-to-exercise allocation method in the Audit Guidelines and the TSB-M was not the same as methodologies that had been applied in subsequent administrative law judge determinations and a State Tax Commission decision.[7] We also noted that, even though the administrative law judges' determinations could not be used as precedent,[8] they could lead a reasonable taxpayer to conclude that stock option income could also properly be allocated based on the allocation factors for the year of receipt alone or in combination with other years.

### A. The *Stuckless* Decision

At the time of the Tax Section Report, Administrative Law Judge Thomas C. Sacca had sustained the use of the methodology set forth in TSB-M-95(3)(I) for allocating the compensable portion of stock option gain in *Matter of Stuckless*.[9] About one month after the Tax Section Report was published, the New York Tax Appeals Tribunal rejected the use of the TSB-M methodology by the Division of Taxation in the *Stuckless* case and determined that the fair market value of the stock as to which the

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[4] The compensable portion of an employee stock option begins on the date of grant and ends on the date of exercise. *Michaelsen v. New York State Tax Commission*, 67 NY2d. 579 (1986).
[5] TSB-M-95(3)(I) (Nov. 21, 1995).
[6] Income Tax District Office Audit Manual, Section HN.8.1.12, State of New York, Department of Taxation and Finance (Nov. 26, 1997).
[7] *Matter of Rawl*, Admin. Law Judge (Dec. 10, 1998) [allocation based on year of exercise]; *Matter of Tobin*, TSB-H-83(43)I, State Tax Commission (March 4, 1983) [year of exercise]; *Matter of Sadik-Kahn*, Admin. Law Judge (July 19, 1990) [allocation based on retirement year and preceding three years].
[8] N.Y. Tax Law Section 2010(5).
[9] *Matter of Stuckless*, Admin Law Judge (July 8, 2004).

taxpayer held options on the day he moved out of New York must be used to determine the gain realized for New York State income tax purposes.[10]

The Division of Taxation filed a motion for reargument on September 9, 2005 that was granted by the Tax Appeals Tribunal on December 15, 2005. On August 17, 2006,[11] the Tax Appeals Tribunal withdrew its May 12, 2005 decision and rendered a new decision holding that the regulations under Tax Law section 631(c) as currently written require an allocation of nonresident compensation based upon the number of days worked inside and outside the state in the year the compensation was received. Since the nonresident petitioner had no work days in New York during the periods when the compensation was received, the notice of deficiency was cancelled. The Tribunal acknowledged that new regulations could be formally adopted that provide a different rule for stock options such as those granted to the petitioner, but it held that TSB-M-95(3)(I), issued without the formality required of a regulation under the State Administrative Procedure Act, was inconsistent with the regulations and therefore invalid.

### B. The Legislative Response to the Withdrawn Stuckless Opinion

Chapter 62 of the Laws of 2006 added Sections 631(g) and 638(c) to the Tax Law to give the Commissioner of Taxation and Finance the authority to issue regulations providing for the allocation of income resulting from stock options, stock appreciation rights and restricted stock to nonresidents and part-year residents.[12] The Chapter also provides in part as follows:

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[10] *Matter of Stuckless*, Tax App. Tribunal (May 12, 2005) [decision withdrawn and replaced].
[11] On August 17, 2006 a majority of the members of the Tax Appeals Tribunal had not been members on May 12, 2005.
[12] Paragraphs 1 and 2 (Part N), effective April 28, 2006.

> § 3. The commissioner of taxation and finance shall propose the rules and regulations referenced in subsection (g) of section 631 and subsection (c) of section 638 of the Tax Law, as added by sections one and two of this act, respectively, within one hundred eighty days of the effective date of this act. Such rules and regulations may apply to taxable years beginning on or after January 1, 2006 and shall be controlling for such taxable years notwithstanding any tax appeals tribunal decision to the contrary.[13]

The Memorandum of Support states:

> The recent decision by the Tax Appeals Tribunal in the *Matter of E. Randall Stuckless* [the May 12, 2005 decision] 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 Bureau Memorandum, the memorandum was ignored by the Tribunal in Stuckless. As a result, there currently are no clear rules for taxpayers, practitioners and 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 Sate Administrative Procedure Act regulation process.[14]

The August 17, 2006 *Stuckless* decision further demonstrates the need for definitive regulations relating to income allocation in this area. The Tribunal's specific acknowledgement that new regulations on the subject may be formally adopted, together with the authority (listed above) that makes adopting such regulations possible, support the view that such regulations are appropriate to avoid confusion in this area.

## II. Draft Proposed Regulations

### A. General Description

On August 9, 2006, The Regulations Bureau, Technical Services Division of the Department of Taxation and Finance, asked for our preliminary comments on draft proposed regulations.[15] The draft would renumber current sections 132.24 and 132.25 as

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[13] Paragraph 3 (Part N), effective April 28, 2006.

[14] 2006-2007 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support, Part QQ.

[15] The new Regulations are to be proposed by October 23, 2006. The draft proposed regulations are attached to this report as an addendum.

132.25 and 132.26 respectively and would add a new section 132.24 to provide a separate set of new rules for stock options, stock appreciation rights and restricted stock.

The draft proposed regulations generally present a clear, internally consistent and rigorous framework for allocating the income from stock options, stock appreciation rights and restricted stock over a grant to vesting allocation period as opposed to the grant to exercise allocation period set forth in TSB-M-95(3)(I). This is an approach that we support and, in recent discussions with the Regulations Bureau, indeed suggested. While we recognize that the determination of the amount of compensation is made from grant to exercise (and may therefore take into account changes in value having nothing to do with the period of required service), the choice of a grant-to-vesting allocation period for the purposes at issue here makes the most sense because, at the time of vesting, the individual has performed all the service related conditions necessary to exercise the option or right, and the resulting allocation will thereby track the underlying services. As noted above, the grant to vesting period is also similar to the Internal Revenue Service rules for nonresident aliens.

Other methods of allocation could be used alone or in combination with the grant to vesting procedure. For example, if an employee were a resident for the entire grant to vesting period, the entire compensation might could be considered New York source income. Presumably, the corollary to such an approach would be that no income would be allocated to New York in the case of an employee who was a nonresident for the entire grant to vesting period. The advantage of such rules might be that they would tend to avoid tax planning. They might also help avoid tax traps for the unwary in those cases in which the employee in question would not necessarily be aware of the need to count days

worked within and outside of New York during the grant to vesting period. However, we believe that the introduction of these types of exceptions to the general day-counting rule may give rise to additional complexity and might not be wholly consistent with the statute. For these reasons, we do not recommend this approach.

Congruence with the federal rules is also wise in this instance in that the federal rules can be looked to as setting useful precedent in the area of nonresident income allocation.

We note our concern that employers and employees may not be aware of the need for proper records to show relevant allocations to the number of days worked within and without New York between the date that options are granted to employees and the date those options vest. Because of the peculiarly significant impact on day-to-day administration and record-keeping, we respectfully suggest that the Department of Taxation and Finance affirmatively undertake a communications initiative to New York employers regarding the importance of keeping such records and the value of making their employees aware of these issues.

### B. Specific Comments of the Draft Proposed Regulations

While we enthusiastically support the approach in the draft Regulations, we do have the following technical questions and comments on the draft:

It would be convenient if the definitions used in the regulations were in alphabetical order.

There is an important difference between the New York and federal treatment of gain in the case of statutory options. New York taxes gain on statutory options like gain on nonqualified options for purposes of nonresident and part-year resident allocations.

Assuming the statutory requirements are met, federal law treats the entire appreciation in statutory options as capital gain. For New York purposes, however, the portion of the gain allocated to New York is treated as compensation taxable as ordinary income. The definition of Compensation[16] in the draft correctly follows the holding in *Michaelsen*, and by a special rule for statutory options, limits the allocable income to the lesser of the gain realized at the time of exercise or the gain recognized at the time of sale.

In the draft proposed regulations, the definition of Compensation for options that are not statutory options is based on "federal compensation." Because "federal compensation" is not a term of art in the Internal Revenue Code or the Tax Law, we would suggest that the words "federal compensation" be replaced by "compensation" and that "compensation" be defined as the income attributable to stock options, stock appreciation rights or restricted stock which is: (i) in the case of nonstatutory options, stock appreciation rights or restricted stock, treated as compensation for federal tax purposes and required to be included in federal gross income for the taxable year, or (ii) in the case of statutory stock options, treated as capital gain for federal income tax purposes but treated as compensation for New York State income tax purposes and required to be included in federal gross income for the taxable year.

Furthermore the words "federal adjusted gross income" at the end of the same sentence should be replaced by the words "federal gross income" since an optionee who was not an employee could have federal adjustments related to the option.

[16] Paragraph 132.24(c)(1).

The specific references to Internal Revenue Code sections 83(a), 83(b), 422 and 423 may prove inconvenient if the Code is amended in the future. A more generic description of such options may be helpful.

In subparagraphs (i), (ii) and (iii) of the definition of Allocation period, 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."

The design of the draft proposed regulation is to compute the New York workday fraction for the period between the date of grant and the date of vesting of a stock option, a stock appreciation right or restricted stock. It is therefore important that the date of vesting be clearly defined. Subparagraphs (i) and (iii) of the definition of Allocation period use two different formulations to describe vesting. We would suggest that both subparagraphs use the phrase "the date the stock is vested (transferable or not subject to substantial risk of forfeiture)." If the phrase "the date on which all employment-related conditions for exercise of the option have been satisfied" is retained, at least the word "employment-related" should be replaced by the word "service-related." Options are often granted to independent contractors and other people such as directors who are not employees but who perform services. The additional events listed in subparagraph (iii) do not add anything to the definition and should be eliminated.

Section 132.25 of the proposed regulations should indicate that the allocation methods set forth in Section 132.24 are the presumptive methods for allocation of the compensation element of stock options, stock appreciation rights or restricted stock. We

note that any rule that involves a fixed measuring period will occasionally result in the possibility that the treatment of an individual taxpayer may be distinctly inappropriate by inadvertence or by design. We believe, nevertheless, that other methods of allocation (whether at the insistence of the taxpayer or the Department) should be used rarely unless they are clearly necessary to reflect income accurately. The draft Regulation in its present form suggests that the allocation method 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 Department auditors as well as taxpayers may feel free to apply other methods. This would result in confusion of the type that the regulations are designed to eliminate. The method prescribed in the new Regulation is sensible and it should be required and respected by taxpayers and the Department except in very unusual cases. The proposed regulations should make clear that the presumption that applies to the use of the allocation method under Section 132.24 is stronger than the presumption that applies to the allocation principles that apply to Sections 132.15 through 132.23 of the Regulations.

When an alternative method is used on a return, the taxpayer should be required to explain its use on the return, but the Regulation, by requiring that it be explained on the return in all cases, suggests that a taxpayer cannot raise the possibility of an alternative method other than on a return (e.g., in the context of an audit). Taxpayers will often feel that another method is appropriate but will not bother claiming it on a return because the amounts involved are small. The effect of the amounts involved may be increased as a result of adjustments made at an audit, and a taxpayer should be free to claim an alternative method in the context of an audit (subject to the strong presumption

suggested above). The rationale here is the same as that which led to the abandonment of the old 30-day rule for electing to file combined reports.

Pursuant to a recent amendment to the regulations, the new regulations would apply retroactively to tax years beginning on or after January 1, 2006. Given the uncertainty that prevailed prior to the most recent decision in *Stuckless,* and the fact that many taxpayers may have been applying the grant to exercise allocation method set forth in TSB-M-95(3)(I), an election to use the grant to exercise method has been provided for the year 2006. We suggest that such election be made available for all open years, and that for ease of reference it be specifically cross-referenced in Section 5 of the regulations. Consideration might also be given to allowing taxpayers to choose to apply the *Stuckless* rule in this limited set of circumstances.

Finally, because of the sweeping holding in *Stuckless* that TSB-M-95(3)(I) is ineffective to modify the plain meaning of the regulations, the Department might wish to review other situations where amended regulations might be necessary to effect the intention of other provisions of the Technical Service Bureau Memorandum.

## Appendix – Text of Proposed Regulations

STATE OF NEW YORK

DEPARTMENT OF TAXATION AND FINANCE

COMMISSIONER OF TAXATION AND FINANCE

ALBANY, NEW YORK

Pursuant to the authority contained in subdivision First of section 171 and subsection (a) of section 697 of the Tax Law, the Commissioner of Taxation and Finance hereby proposes to make and adopt the following amendments to the New York State Income Tax Regulations, as published in Subchapter A of Chapter II of Title 20 of the Official Compilation of Codes, Rules and Regulations of the State of New York, such amendments to read as follows:

Section 1. The heading note for Part 132 of such regulations is amended to read as follows:

> "Note:" Except for [section] sections 132.19 and 132.24, this Part does not reflect amendments to the Tax Law made by the Tax Reform and Reduction Act of 1987 (Chapter 28 of the Laws of 1987) and certain other amendments.

Section 2. Sections 132.24 and 132.25 of such regulations are renumbered to be sections 132.25 and 132.26, respectively, and a new section 132.24 is added to read as follows:

Section 132.24 Stock options, stock appreciation rights and restricted stock (Tax Law, section 631(g))

(a) "General." A nonresident individual has New York source income from compensation received from stock options, stock appreciation rights or restricted stock if at any time during the allocation period the nonresident individual performed services in New York State for the corporation granting such options, rights or stock ("grantor"). A nonresident individual's New York source income from compensation received from stock options, stock appreciation rights or restricted stock is realized when the income is realized for federal income tax purposes and is reportable to New York State in the taxable year that the income is included in the individual's federal adjusted gross income.

(b) "Computation of New York source income." New York source income from stock options, stock appreciation rights or restricted stock is the amount determined by multiplying the compensation by the New York workday fraction for the applicable allocation period.

(c) "Definitions." For purposes of this section:

(1) "Compensation" means the income attributable to stock options, stock appreciation rights or restricted stock that is treated as compensation for federal income tax purposes and that is required to be included in federal adjusted gross income for the taxable year. In the case of statutory stock options (Internal Revenue Code, sections 422 and 423), the amount of income recognized for federal income tax purposes may be reported as a capital gain, and in such case, the amount of the capital gain that is compensation is limited to the amount that is the lesser of:

(i) the difference between the option price and the fair market value of the stock at the time the option is exercised; or

(ii) the gain (but not the loss) actually recognized for federal income tax purposes at the time the stock is sold.

(2) "New York workday fraction" is a fraction the numerator of which is the number of days worked within New York State during the allocation period and the denominator of which is the number of days worked both within and without New York State during the allocation period. See section 132.18 of this Part for more information about what constitutes a working day within New York.

(3) "Allocation period" is:

(i) in the case of statutory stock options (Internal Revenue Code, sections 422 and 423), nonstatutory stock options that do not have a readily ascertainable fair market value at the time of grant, and stock appreciation rights,

"(a)" the period of time from the date of grant to the date on which all service-related conditions for exercise of the option or right have been satisfied (the date that the option or right is vested) or, if the option or right is vested at the time of grant, the same period of time that applies to regular, non-stock-based remuneration from the grantor during the taxable year of the grant, or

"(b)" for a taxable year beginning in 2006, if elected by the individual, the period of time from the date of grant to the earliest of the date that the option or right is exercised, the date that the individual's services terminate, or the date that the compensation is recognized for federal income tax purposes;

(ii) in the case of nonstatutory stock options that have a readily ascertainable fair market value at the time of grant (Internal Revenue Code, section 83(a)) and restricted stock where an election under section 83(b) of the Internal Revenue Code

is made, the same period of time that applies to regular, non-stock-based remuneration from the grantor during the taxable year the option was granted or the restricted stock was received; or

(iii) in the case of restricted stock where an election under section 83(b) of the Internal Revenue Code is not made, the period of time from the date that the stock was received to the earliest of the date that the stock is substantially vested (transferable or not subject to substantial risk of forfeiture), the date that the individual's services terminate, or the date that the stock is sold, except that, with respect to the portion of the compensation related to the stock that is attributable to dividends paid on the stock, the same period of time that applies to regular, non-stock-based remuneration from the grantor during the taxable year that such dividends were received.

In all cases, the allocation period may span multiple years and may include New York State resident periods.

(d) "Examples."

"Example 1:" On April 1, 2007, Company B compensates employee S with a grant of nonstatutory stock options that do not have a readily ascertainable fair market value when granted. The stock options permit S to purchase 10,000 shares of Company B stock for $5 per share. The stock options do not become exercisable unless and until S performs services for Company B (or a related company) for the next 5 years. S continues to work for Company B for the next 15 years. From April 1, 2007 through March 31, 2011, S is a New York State nonresident who works within and without New York State. S's workdays within New York State during this time period total 720 days, and S's workdays both within and without New York State for this time period total 960

days. From April 1, 2011 to August 15, 2013, S continues to be a nonresident of New York State, but during this time period, only performs services for Company B outside New York State. From April 1, 2011 to March 31, 2012 (the date that the options become exercisable), S has a total of 240 working days, all of which were services performed outside New York State. On August 15, 2013, S exercises the options when the stock is worth $12 per share. S recognizes $70,000 in compensation for federal income tax purposes (($12-$5) x 10,000) in 2013. S's allocation period for computing New York source income is the 5-year period between the date of grant (April 1, 2007) and the date that the stock options become exercisable (March 31, 2012) because, as of that date, S has performed all services necessary for exercise of the options. The services performed after the date that the stock options became exercisable are not taken into account in allocating the compensation from the stock options. Therefore, S's New York workday fraction for the 5-year allocation period is 720/1200, and $42,000 of the $70,000 compensation recognized in 2013 is New York source income in 2013 (720/1200 x $70,000 = $42,000).

"Example 2:" Same facts as in "Example 1" except that the options granted were statutory stock options and the stock is sold on September 17, 2014, for $11 per share. From August 16, 2013 to September 17, 2014, S continues to be a New York State nonresident who performs no services in New York State. In this situation, S recognizes a capital gain for federal income tax purposes of $60,000 (($11-$5) x 10,000) when the stock is sold in 2014. S's compensation is limited to $60,000 since the $60,000 gain is less than the $70,000 difference between the option price and the fair market value at the time of exercise (($12-$5) x 10,000). S's allocation period for computing New York

source income is the 5-year period between the date of grant (April 1, 2007) and the date that the stock options became exercisable (March 31, 2012) because, as of that date, S has performed all services necessary for exercise of the options. Therefore, S's New York workday fraction is 720/1200, and $36,000 of the $60,000 compensation recognized in 2014 is New York source income in 2014 (720/1200 x $60,000 = $36,000).

"Example 3:" Same facts as in "Example 2" except that the stock sells for $14 per share. In this situation, S recognizes a capital gain for federal income tax purposes of $90,000 (($14-$5) x 10,000) when the stock is sold in 2014. S's compensation is limited to $70,000, the difference between the option price and the fair market value at the time of exercise (($12-$5) x 10,000), and $42,000 of the $70,000 compensation recognized in 2014 is New York source income in 2014 (720/1200 x $70,000 = $42,000). The $20,000 increase in the value of stock after the exercise date is considered investment income, and is not New York source income for S.

Section 3. Section 132.25 of such regulations is amended to read as follows:

Section 132.25 Other methods of allocation.

Sections 132.15 through [132.23] 132.24 of this Part are designed to apportion and allocate to New York State, in a fair and equitable manner, a nonresident's items of income, gain, loss and deduction attributable to a business, trade, profession or occupation carried on partly within and partly without New York State. Where the methods provided under those sections do not so allocate and apportion those items, the [department] Department may require a taxpayer to apportion and allocate those items under such method as it prescribes, as long as the prescribed method results in a fair and equitable apportionment and allocation. A nonresident individual may submit an

alternative method of apportionment and allocation with respect to items of income, gain, loss and deduction attributable to a business, trade, profession or occupation carried on partly within and partly without New York State. The proposed method must be fully explained in the taxpayer's New York State nonresident personal income tax return. If the method proposed by the taxpayer is approved by the [department] Department, it may be used in lieu of the applicable method under sections 132.15 through [132.22] 132.24 of this Part.

Section 4. A new section 154.6 of such regulations is added to read as follows:

Section 154.6 Stock options, stock appreciation rights and restricted stock (Tax Law, section 638(c))

(a) Where an individual changes resident status during the taxable year, the amount of New York source income from compensation (see section 132.24(c)(1)) received from stock options, stock appreciation rights or restricted stock, in the taxable year that such income is included in the individual's federal adjusted gross income (as either ordinary income or capital gain income), is dependent on the individual's resident status at the time that the compensation is recognized for federal income tax purposes.

(b) If the compensation is recognized during the resident period, the entire amount of compensation recognized for federal income tax purposes is includable in New York source income. In the case of statutory stock options (Internal Revenue Code, sections 422 and 423), the entire amount of gain or loss recognized for federal income tax purposes (both the compensation element and any appreciation in the value of the stock after the exercise date) is includable in New York source income.

(c) If the compensation is recognized during the nonresident period, the amount includable in New York source income is determined using the allocation methods described in section 132.24 of this Title.

Section 5. These amendments shall apply to taxable years beginning on or after January 1, 2006.

Dated: Albany, New York
October XX , 2006

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Andrew S. Eristoff
Commissioner of Taxation and Finance