

New York State Tax Treatment of Stock Options, Restricted Stock, and Stock Appreciation Rights Received by Nonresidents and Part-Year Residents

Chapter 62 of the Laws of 2006 added sections 631(g) and 638(c) to the Tax Law. These sections require nonresidents and part-year residents who have been granted stock options, restricted stock, or stock appreciation rights and who performed services within New York State during the grant period to allocate to New York State their compensation income attributable to these items according to regulations prescribed by the Commissioner of Taxation and Finance. The law also required that the regulations regarding the allocation of such compensation income be proposed within 180 days of the effective date of the law (by October 23, 2006). The regulations were proposed by the Commissioner on October 10, 2006, and adopted on December 12, 2006.

These amendments to the Personal Income Tax Regulations (Parts 132 and 154) address the allocation method for tax years beginning on or after January 1, 2006.

In 1995, the Tax Department issued TSB-M-95(3)I, which explained the methods to be used by nonresidents and part-year residents to determine the amount of compensation income attributable to stock options, restricted stock, and stock appreciation rights that is includable in New York source income. TSB-M-95(3)I generally called for a grant-to-exercise allocation method for stock options, nonstatutory stock options without a readily ascertainable fair market value, and stock appreciation rights.

This memorandum supersedes TSB-M-95(3)I. It explains the New York State tax treatment of stock options, restricted stock, and stock appreciation rights for tax years beginning on or after January 1, 2006, reflecting the new law and regulations. It reflects the general use in the regulations of a grant-to-vest allocation method for stock options, nonstatutory stock options without a readily ascertainable fair market value, and stock appreciation rights.

Additionally, on October 12, 2006, the Tax Department issued TSB-M-06(7)I, which provided guidance pertaining to the allocation of compensation income attributable to these items for tax year 2005 and any prior year where the statute of limitations is still open. The October 12, 2006, memorandum was issued in response to a Tax Appeals Tribunal decision (*Matter of Stuckless*, August 17, 2006) that found that the allocation method called for in TSB-M-95(3)I was not a valid interpretation of the Tax Department's regulations in effect at that time. Please refer to TSB-M-06(7)I for guidance on the proper allocation of such compensation income for these prior periods.

Nonresidents

General information

Section 601(e) of the Tax Law imposes a personal income tax on the portion of a nonresident individual's taxable income that is derived from New York sources. The tax is equal to the tax computed as if the individual were a New York State resident for the entire year, reduced by certain credits, multiplied by the income percentage.

The numerator of the fraction used to compute the income percentage is the individual's New York source income. The New York source income of a nonresident individual is the sum of the items of income, gain, loss, and deduction entering into federal adjusted gross income derived from or connected with New York sources and any New York addition and subtraction modifications under sections 612(b) and 612(c) of the Tax Law that relate to income derived from New York sources (i.e., New York adjusted gross income from New York sources). The denominator of the fraction used to compute the income percentage is the nonresident individual's New York adjusted gross income from all sources for the entire year.

In the case of a nonresident individual who works in New York State, the portion of the individual's compensation related to stock options, restricted stock, and stock appreciation rights that is New York source income is determined by multiplying such compensation by the *New York workday fraction*.

The *New York workday fraction* is a fraction whose numerator is the number of days worked within New York State for the grantor during the allocation period and whose denominator is the number of days worked both within and without New York State for the grantor during the allocation period.¹ The allocation period may span multiple years and may include periods in which the nonresident was formerly a New York State resident. See section 132.18 of the Personal Income Tax Regulations for more information about what constitutes a working day within New York.

The sections that follow discuss in more detail the tax treatment and methods for determining New York source income from compensation relating to stock options, restricted stock, and stock appreciation rights for nonresidents.

Statutory stock options

Statutory stock options are options governed by Internal Revenue Code (IRC) sections 421 through 424 that impose restrictions on both the grantor and the individual. Statutory stock options include incentive stock options as provided in section 422 of the IRC and options issued pursuant to employee stock purchase plans as provided in section 423 of the IRC.

Income from statutory stock options for both federal and New York State income tax purposes is recognized on the date the stock is sold. If the holding period requirement and other federal statutory requirements have been met and there is a gain on the sale of the stock, the gain (the excess of the selling price over the option price) is given capital gain treatment for federal income tax purposes. (If there is a loss on the sale of the stock, the loss is treated as a capital loss.) If the holding period requirement or another federal statutory requirement is not met and there is a gain on the sale of the stock, the gain is treated as ordinary income for federal income tax purposes up to the amount by which the stock's fair market value exceeded the option price at the time the option was exercised. Any excess gain is given capital gain treatment. (If there is a loss on the sale of the stock, it is treated as a capital loss and there is no ordinary income for federal income tax purposes.)

¹ This includes days worked during the allocation period for a corporation related to the grantor and in consideration (in whole or in part) for the compensation from the option, stock, or right.

The New York State Court of Appeals decision in *Matter of Michaelsen v. New York State Tax Commission* (67 N.Y. 2d 579) established that a nonresident individual employed in New York State who received an incentive stock option (IRC section 422), exercised the option, and subsequently sold the stock at a gain would be subject to New York State personal income tax only on that portion of the gain that represented the difference between the option price and the fair market value of the stock at the time the option was exercised. The court held that this difference constituted compensation for services performed in New York State. Any further appreciation in the value of the stock after the exercise date was investment income not taxable to a nonresident. It is important to note from this decision that, even if the gain on the sale of the stock qualifies for federal capital gain treatment, the portion of the capital gain that represents the difference between fair market value of the stock at the time of exercise and the option price is still compensation.

Based on *Michaelsen*, compensation from statutory stock options is as follows: (1) If there is a gain on the sale of the stock and the stock sold for an amount greater than the fair market value of the stock at the time the option was exercised, compensation is the difference between the option price and the fair market value of the stock on the date the option was exercised. (2) If there is a gain on the sale of the stock and the stock sold for an amount less than or equal to its fair market value at the time the option was exercised, compensation is the gain actually recognized on the sale of the stock (the difference between the option price and the selling price). (3) If there is a loss on the sale of the stock, there is no compensation, and the federal capital loss is not allowable in computing New York source income.

The allocation period for a statutory stock option is the period of time beginning with the date the option was granted and ending with the date the option vested (the point at which all service-related conditions² necessary for the exercise of the option have been met). If the option vested at the time it was granted, the allocation period is the same period of time that applies to regular, non-stock-based remuneration from the grantor during the taxable year the option was granted.

For a taxable year beginning in 2006 only, instead of the allocation period described in the preceding paragraph, a nonresident individual could elect to use the period of time from the date the option was granted to the earliest of: (1) the date that the option was exercised, (2) the date that the individual's services terminated, or (3) the date that the compensation was recognized for federal income tax purposes. This election was put in place in recognition of the fact that individuals may have relied on TSB-M-95(3)I to determine their withholding and/or estimated tax for 2006.

The New York source portion of statutory stock option compensation is computed by multiplying the compensation attributable to the option by the New York workday fraction computed for the allocation period.

Restricted stock

Restricted stock is governed by section 83 of the IRC. A *restricted stock award* is a grant of company stock in which the recipient's rights in the stock are restricted until the shares vest.

In general, the value of a restricted stock award received by an individual in connection with the performance of services is taxable as compensation for federal income tax purposes in the year

² A *service-related condition* is either a specified period of service or specified performance target(s).

the rights of the individual having the beneficial interest in the stock are substantially vested (transferable or not subject to a substantial risk of forfeiture). However, if the individual makes an election under section 83(b) of the IRC (a section 83(b) election), the value of the stock is included in taxable income (recognized) in the year the stock is received. Furthermore, if the section 83(b) election is not made and the stock is subsequently sold or otherwise disposed of in an arm's length transaction while it is still not substantially vested, compensation is recognized at the time of sale. Based upon the above, the New York tax treatment of compensation attributable to restricted stock is as follows:

- If the section 83(b) election is not made:

The amount of compensation is the difference between the fair market value of the stock at the time the stock becomes substantially vested and the amount, if any, paid for the stock by the individual. However, if the stock is sold in an arm's length transaction before it becomes substantially vested, the amount of compensation is the difference between the amount realized on the sale and the amount paid, if any, for the stock by the individual. In addition, dividends received on the stock before it becomes substantially vested (or before the stock is sold) are also considered compensation in the year in which the dividends are received.

The allocation period is the period of time beginning with the date the stock was received and ending with the earliest of: (1) the date the stock was substantially vested (transferable or not subject to substantial risk of forfeiture), (2) the date the individual's services terminated, or (3) the date the stock was sold. However, with respect to the compensation attributable to dividends paid on the stock, the allocation period is the period of time that applies to regular, non-stock-based remuneration from the grantor during the taxable year that such dividends were received.

The New York source portion of restricted stock compensation when the section 83(b) election is not made is computed by multiplying the compensation attributable to the restricted stock (or the dividends therefrom) by the New York workday fraction computed for the allocation period.

- If the section 83(b) election is made:

The amount of compensation is the difference between the fair market value of the stock on the date that the stock was received and the amount paid for the stock by the individual.

The allocation period is the same period of time that applies to regular, non-stock-based remuneration from the grantor during the taxable year that the restricted stock was received.

The New York source portion of restricted stock compensation where the section 83(b) election is made is computed by multiplying the compensation attributable to the restricted stock by the New York workday fraction computed for the allocation period.

Dividends received on restricted stock when the section 83(b) election has been made are investment income that is not includable in New York source income.

Stock appreciation rights

A *stock appreciation right* is a grant to an individual giving the individual the right at some specific time in the future to receive a cash or stock award equal to the appreciation in value of a certain number of shares of company stock.

Unless subject to section 409A of the IRC (see *American Jobs Creation Act of 2004* below), compensation is the difference between the fair market value of the stock on the date the stock appreciation right is granted and the fair market value of the stock on the date that the stock appreciation right is exercised.

The allocation period is the period of time beginning with the date the right was granted and ending with the date the right vested (the point at which all service-related conditions necessary for the exercise of the right have been met). If the stock appreciation right vested at the time it was granted, the allocation period is the same period of time that applies to regular, non-stock-based remuneration from the grantor during the taxable year the right was granted.

For a taxable year beginning in 2006 only, instead of the allocation period described in the preceding paragraph, a nonresident individual could elect to use the period of time from the date the right was granted to the earliest of: (1) the date that the right was exercised, (2) the date that the individual's services terminated, or (3) the date that the compensation was recognized for federal income tax purposes. This election was put in place in recognition of the fact that individuals may have relied on TSB-M-95(3)I to determine their withholding and/or estimated tax for 2006.

The New York source portion of stock appreciation right compensation is computed by multiplying the compensation attributable to the stock appreciation right by the New York workday fraction computed for the allocation period.

Nonstatutory stock options

In general, *nonstatutory stock options* are options that do not meet the IRC requirements to qualify as statutory stock options or are granted pursuant to a plan or offering that does not qualify. The tax treatment for federal and New York State purposes is dependent upon whether the fair market value of the option can be readily determined at the time of grant.

If a nonstatutory stock option has a readily ascertainable fair market value at the time of grant, the amount of compensation is the difference between the fair market value of the option on the date that the option is granted and the amount paid for the option by the individual.

The allocation period for these nonstatutory stock options is the same period of time that applies to regular, non-stock-based remuneration from the grantor during the taxable year the option was granted.

If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant and is not subject to section 409A of the IRC (see *American Jobs Creation Act of 2004* on page 6), the compensation is determined in the same manner as for statutory stock options. That is, compensation is equal to the difference between the option price and the fair market value of the stock at the time of exercise (see *Statutory stock options* on page 2). However, unlike statutory stock options, compensation for these options is recognized for federal and New York State purposes at the

time of exercise and is therefore not dependent upon the subsequent selling price of the stock. Any gain or loss attributable to further appreciation or depreciation in the value of the stock after the date the option is exercised represents investment income or loss not includable in the New York source income of a nonresident.

The allocation period for these nonstatutory stock options is the period of time beginning with the date the option was granted and ending with the date the option vested (the point at which all service-related conditions necessary for the exercise of the option have been met). If the option vested at the time it was granted, the allocation period is the same period of time that applies to regular, non-stock-based remuneration from the grantor during the taxable year the option was granted.

For a taxable year beginning in 2006 only, instead of the allocation period described in the preceding paragraph, a nonresident individual could elect to use the period of time from the date the option was granted to the earliest of: (1) the date that the option was exercised, (2) the date that the individual's services terminated, or (3) the date that the compensation was recognized for federal income tax purposes. This election was put in place in recognition of the fact that individuals may have relied on TSB-M-95(3)I to determine their withholding and/or estimated tax for 2006.

The New York source portion of nonstatutory stock option compensation is computed by multiplying the compensation attributable to the stock option by the New York workday fraction computed for the allocation period.

American Jobs Creation Act of 2004

Section 409A was added to the IRC as part of the American Jobs Creation Act of 2004 (Pub. Law No. 108-357). Under this law, certain nonstatutory stock options and stock appreciation rights (in general, options or rights whose exercise price is less than the fair market value of the stock on the date of the grant) are considered to be nonqualified deferred compensation plans subject to the provisions of section 409A of the IRC. Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includable in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met. The new law applies to all amounts payable to a participant from a deferred compensation plan after December 31, 2004, unless (1) the participant was vested in such amount by December 31, 2004, and (2) the plan was not materially amended after October 3, 2004. The Internal Revenue Service has recently issued final regulations for section 409A, *Application of Section 409A to Nonqualified Deferred Compensation Plans* (72 Fed. Reg. 19,243 (April 17, 2007)).

For nonstatutory stock options and stock appreciation rights subject to section 409A that do not meet the requirements of such section, compensation equals the portion of the total amount deferred under that plan that, as of the end of the calendar year, is not subject to a substantial risk of forfeiture (as defined for purposes of section 409A) and has not been included in income in a previous year plus any amounts of deferred compensation paid or made available to the individual under the plan for the current calendar year. The amount deferred as of the end of the calendar year is the amount that would be required to be included in income if the option or right were immediately exercisable and exercised as of the close of the calendar year (the fair market value of the underlying stock less the sum of the exercise price and any amount paid by the individual for the option or right).

The allocation period for these options and rights is the period of time beginning with the date the option or right was granted and ending with the date the option or right vested (the point at which all service-related conditions necessary for the exercise of the option or right have been met). If the option or right vested at the time it was granted, the allocation period is the same period of time that applies to regular, non-stock-based remuneration from the grantor during the taxable year the option or right was granted.

The New York source portion of compensation for these options and rights is computed by multiplying the compensation attributable to the option or right by the New York workday fraction computed for the allocation period.

Alternative allocation

Section 132.24 of the Personal Income Tax Regulations is designed to apportion and allocate, in a fair and equitable manner, a nonresident's or part-year resident's (if compensation is recognized during the nonresident period) compensation income attributable to stock options, restricted stock, and stock appreciation rights to New York State. Under section 132.25 of the Regulations, where the methods provided do not result in a fair and equitable allocation, the Department may require or an individual may submit an alternative allocation method.

Part-year residents

When an individual changes resident status during the taxable year, the amount of New York source income from compensation received from stock options, restricted stock, or stock appreciation rights in the taxable year that is included in the individual's federal 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.

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, 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 date the option is exercised) is includable in New York source income.

If the compensation is recognized during the nonresident period, the amount includable in New York source income is determined using the allocation methods previously described under the heading, *Nonresidents*.

The above rules for a change of resident status for New York State purposes also apply if an individual has a change of resident status for Yonkers tax purposes. However, see *City of Yonkers Nonresident Earnings Tax* below for information on what income is reportable in the Yonkers nonresident period.

As is the case for a change of resident status for New York State purposes, when an individual has a change of resident status for New York City during the taxable year, the amount of New York City compensation received from stock options, restricted stock, or stock appreciation rights in the taxable year that is included in the individual's federal gross income (as either ordinary income or capital gain income) is also dependent on the individual's resident status at the time that the compensation is recognized for federal income tax purposes. If the compensation is recognized

during the New York City resident period, the entire amount of the compensation 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 City source income. However, if the compensation is recognized during the nonresident period, the compensation is not subject to New York City tax.

City of Yonkers Nonresident Earnings Tax

Yonkers nonresident earnings tax is imposed on an individual's wages, as defined in section 3401(a) of the IRC, earned within Yonkers and on an individual's net earnings from self-employment, generally as defined in section 1402(a) of the IRC, earned within Yonkers.

Section 3401(a) of the IRC defines wages subject to withholding for federal income tax purposes.

Compensation attributable to statutory stock options does not constitute wages under section 3401(a). Accordingly, compensation attributable to these options is not includable in taxable wages subject to Yonkers nonresident earnings tax even though the compensation may be subject to New York State tax.

Compensation from nonstatutory stock options, restricted stock, and stock appreciation rights does constitute wages under section 3401(a). Accordingly, compensation attributable to these items would be includable in taxable wages subject to Yonkers nonresident earnings tax if the individual performed services in Yonkers.

If an individual performed services in the city of Yonkers, the compensation is allocated to Yonkers using the same rules that apply to nonresidents of New York State. However, for the New York workday fraction, the days worked within and without the city of Yonkers would be used in place of the days worked within and without New York State.