

Matter of E. Randall Stuckless and Jennifer Olsen: New York Tax Appeals Tribunal Issues Stock-Option Decision

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For years, taxpayers and practitioners have contended that New York's taxation of stock-option income was problematic, in large part because the position was spelled out in a Technical Services Bureau memorandum, not in a statute or regulation. On May 12, the New York State Tax Appeals Tribunal rendered its decision in *Matter of Stuckless*. In that decision, the tribunal rejected New York's long-standing policy on the treatment of a nonresident's stock-option income. The decision calls into question New York's grant-to-exercise methodology for the taxation of option income, thereby providing a basis for alternative allocation methodologies in current audits. The decision may also provide a basis for taxpayers to file claims for a refund of taxes, interest, and penalties that were paid based on the grant-to-exercise method.

Legal Background

Before going into the specifics of the *Stuckless* case, it is important to understand the context of the stock-option issue that arose in the case. For federal purposes, an employee who receives stock options is generally not subject to income tax when the option is granted. When the option is exercised, however, the gain attributable to the difference between (1) the option price (typically, the stock's fair-market value at the time of the grant) and (2) the fair-market value of the stock on the date of exercise is deemed taxable compensation. On a subsequent sale of the stock, the employee is subject to tax on any postexercise appreciation, but that income generally is a capital gain and subject to tax accordingly.

For New York residents, the rules are simple and easily applied, because their New York taxable in-

come is based on their federal taxable income. The rules are less clear when applied to nonresidents.

The problem started in 1986, in *Michaelsen v. New York State Tax Commission*,¹ in which the New York Court of Appeals ruled that nonresidents who are granted stock options in connection with their New York employment are taxed on income from the exercise of those options based on the difference between the option (or grant) price and the fair-market value of the stock at the time the option is exercised. Also, the Court of Appeals held that that difference constituted compensation for services rendered. Any further appreciation in the value of the stock after the exercise date, however, was investment income and therefore not taxable to a nonresident.

But the *Michaelsen* decision fell short in one very important respect. The case did not instruct nonresident taxpayers on how to allocate the taxable portion of their stock-option income to New York when only some services are performed in New York during the grant-to-exercise period. Also, what if the taxpayer performs no work in New York during the year of exercise? Are workdays for prior years taken into account? *Michaelsen* did not address those questions.

The *Stuckless* decision may also provide a basis for taxpayers to file claims for a refund of taxes, interest, and penalties.

However, in November 1995, the New York State Department of Taxation and Finance issued a Technical Services Bureau memorandum that provided

¹67 N.Y.2d 579, 505 N.Y.S.2d 585, 496 N.E.2d 674 (1986).

specific rules in situations like this.² The memorandum, which was based on the department's interpretation of the *Michaelsen* decision, required that stock-option income be allocated to New York based on the taxpayer's New York workdays during the period between the grant and exercise of each option.³ The memorandum appeared to change the department's long-standing approach, which, as was the situation in *Michaelsen* and earlier cases, focused only on allocation factors in the year of receipt.

Since the issuance of the memorandum, taxpayers have argued that the grant-to-exercise method should be inapplicable to a variety of different circumstances. One taxpayer successfully precluded the tax department from retroactively applying the memorandum to years before 1995.⁴ However, over the years, most taxpayers and taxpayer representatives resigned themselves to the fact that the methodology in the memorandum was going to be followed by auditors. After a while, the memorandum has had the effect of a law change or a regulation — it became the “rule” in all stock-option cases.

Stuckless will most certainly change that.

The *Stuckless* Facts

E. Randall Stuckless was granted incentive stock options by his employer, Microsoft Corp., in 1991 and 1992. At the time 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 such options were granted to “attract and retain the best available personnel.”

In September 1996 Stuckless moved to Seattle. He resided in Washington until he moved back to New York in July 1998. During that period, Stuckless continued to work for Microsoft. He was, however, a nonresident of New York and performed no work in New York. 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 without New York for the same period.

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 this 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.

The *Stuckless* Decision

The New York State Tax Appeals Tribunal phrased the question presented in *Stuckless* as “whether the stock options here are to be valued based on the Court of Appeals decision in *Michaelsen* and, if so, does that Court's decision require a multiyear ‘compensable period’ for allocation of the gain as prescribed in the Division's TSB-M-95(3)I.”

In answering that question, the tribunal recognized that the options should be valued based on *Michaelsen*. Accordingly, the tribunal held that Stuckless realized the gain derived from his options when he exercised them, and that the value of the gain was to be determined by subtracting the option price from the fair market value of the stock at the time of exercise.

The tribunal disagreed, however, with the manner in which the department allocated that gain. According to the tribunal, the department erred in seeking to tax that portion of the stock-option gain that was earned while Stuckless lived and worked in Washington:

While we agree with the Administrative Law Judge that petitioner secured his stock options while employed in New York and that accretions to the value of the stock while he lived and worked in New York are properly subject to New York tax, we do not agree that because the options were granted while petitioner was employed in New York that . . . the embracing arms of the New York Tax Law [extend] to accretions in value of the stock earned as

²See TSB-M-95(3)I, Nov. 21, 1995.

³This grant-to-exercise allocation applies unless the employee exercises an option after terminating employment with the employer who granted the option. In that situation, the compensable period, and thus the allocation, is limited to the days worked both in and out of the state between the date of the option grant and the date of employment termination.

⁴In *Matter of Rawl*, Administrative Law Judge (Dec. 11, 1998), the Division of Tax Appeals refused to allow the retroactive application of the grant-to-exercise rule in the memorandum, favoring instead an allocation based solely on the taxpayer's allocation factors for the year of exercise. The authors' firm represented the taxpayer in *Rawl*.

compensation during years when petitioner worked and lived in another state.

In other words, 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 specifically 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.

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In reaching its holding, the tribunal ruled on two crucial points. First, it held that the Court of Appeals' decision in *Michaelsen* does *not* require the use of the grant-to-exercise allocation methodology as provided for in TSB-M-95(3)I:

The Division appears to argue that the decision of the Court of Appeals in *Michaelsen* required that a nonresident's stock option income be allocated to New York based upon a date of grant to date of allocation period rule which the Division adopted in TSB-M-95(3)I [T]he Division's position is rejected The Court of Appeals decision *did not require* the grant to exercise allocation period rule adopted by the Division in its Memorandum.

Second, the tribunal recognized that the memorandum is an interpretive document only and does not carry the force or effect of law:

The Memorandum is not a regulation and does not carry the force and effect of law. It is an informational and interpretive document to give guidance to taxpayers. [W]e do not regard it as legal authority.

Those two factors — that *Michaelsen* does not mandate the grant-to-exercise method and that the memorandum has no legal authority — led the tribunal to employ its own alternative allocation methodology. The tribunal noted that alternative methodologies are permitted by 20 NYCRR section 132.24.

Obviously, for taxpayers and tax practitioners who have battled with the department over the years about the validity of the memorandum and the department's position on stock options, the *Stuckless* decision can be seen as a victory. Surely, the decision

will affect past and current audits to the benefit of many taxpayers. And while the tribunal certainly applied an interesting and unique twist to the stock-option issue, questions still remain about the application of its reasoning. The tribunal seemed to base its reasoning on the fact that New York's method for "allocating" gain from the exercise of stock options presumably allowed the department to tax accretions in the value of options that occurred while the taxpayer was employed in Washington — after he left New York. The tribunal argued that those accretions in value were "part of petitioner's compensation for services rendered [in Washington] and . . . not subject to New York State tax."

The tribunal's analysis raises an interesting question about the distinction between subjecting income to *tax* on one hand and subjecting it merely to an *allocation* on the other. Certainly, under the department's view, while New York may have subjected the full amount of Stuckless's stock-option gain to New York *allocation*, it did not necessarily follow that the full amount of the gain was subject to New York *tax*. This was because Stuckless was allowed to *allocate* the gain based on his New York total workdays over the grant-to-exercise period. And because he had a zero workday allocation in New York from September 1996 through July 1998, he was able to dilute his New York allocation percentage — and therefore reduce the New York source income ultimately subject to New York tax. So in essence, the department would likely take the position that — by allowing Stuckless to dilute his New York apportionment percentage by applying Washington workdays after he left New York — New York was not taxing Stuckless for his post-1996 employment in Washington.

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The tribunal, quite obviously, was not swayed by that line of argument. Instead, it has taken the position that simply including the gain related to posttermination increase in Microsoft's stock price was not permitted in any instance. That position appears to be similar in concept to the allocation/apportionment distinction found in states following the Uniform Division of Income for Tax Purposes Act (UDITPA). For instance, although the term "allocation" is used loosely in the New York tax context when referring to the determination of New York-source income, it has a specific meaning in states following UDITPA. The department's method for

taxing stock options is more akin to “apportionment” used in the corporate and franchise tax context for most of a taxpayer’s business income. Such income is initially included in taxable income but then “apportioned” to the taxing state based on a formula to determine the actual income subject to tax. Indeed, that is exactly the type of methodology set forth by the department in the memorandum. Compare that with the concept of “allocation” in the corporate tax context, in which items of “nonbusiness income” (and gain from the sale of real property) are not subject to apportionment but are instead allocated to a particular state based on the commercial domicile of the corporation (or the location of the real property). The tribunal seems to be favoring an “allocation” approach (as that term is used in the corporate tax context) over an apportionment approach (under which *all* income is apportioned based on a formula), at least in the context of the *Stuckless* facts.

What’s Next?

The tribunal’s decision is now the law of the land. And for taxpayers, that could be quite good news indeed, because the tribunal’s rationale appears to establish new rules for the sourcing of stock options. Obviously, it is too early to tell what long-standing implications the decision will have, but it clearly will have an immediate impact on current personal income tax audits.

Here is our initial view on how that should play out in different scenarios:

1. The *Stuckless* Scenario. Quite clearly, under *Stuckless*, the tax department cannot include the accretions in value of stock options in the computation of New York taxable income after a taxpayer terminates New York employment. Only that portion of the gain attributable to accretions in value between the date of grant and the date of employment termination in New York will be subject to New York tax. For taxpayers like *Stuckless*, that can have good results if their company’s stock price increases substantially after a move from New York.

2. *Stuckless* Reversed. Even if the stock price drops significantly after a taxpayer’s move, it does not appear that taxpayers could be harmed in any way by this decision. For instance, suppose the spread between the grant price and the fair-market value was \$100 on the date a taxpayer left New York. Also suppose that after two years of working outside New York, the taxpayer exercised the options when the spread was only \$30. Even under *Stuckless*, New York would be entitled to tax only the \$30 gain, because that is the amount that would be reported in the taxpayer’s federal adjusted gross income. The *Stuckless* decision would not permit the department to tax any more than the taxpayer’s federal adjusted gross income, absent a statutory change to Tax Law section 612, which requires the

use of federal adjusted gross income as the starting point for the determination of New York taxable income.

3. Stickier *Stuckless* Scenario. What if *Stuckless* came back to New York for a training session or a meeting in 1997? Would the post-1996 accretions now be subject to allocation? *Stuckless* presented a scenario in which a taxpayer completely severed all employment ties with New York after leaving employment in September 1996. He did not come back to New York in the interim period while he was working in Seattle, which led the tribunal to conclude that New York could not tax any accretions in the value of the options during this time. Would it have been any different if *Stuckless* came back for one day during this post-1996 period? Obviously, because the tribunal was not presented with that situation, it did not address it. But taxpayers and the department surely will have to.

4. The ‘Sometimes In-Sometimes Out’ Taxpayer. Many nonresidents work for non-New York employers but occasionally come to New York as part of their employment. Suppose a nonresident works 10 days in New York in Year 1, 20 days in Year 2, 0 days in Year 3, and 15 days in Year 4. Also, suppose that he is given stock options in Year 1 and that he exercised them in Year 4, but that most of the accretions in value of the options occurred in Year 3 — a year in which he had no New York work days. Again, under the tribunal’s rationale, that taxpayer could take the position that none of the Year 3 accretion could be included in the allocation of the stock-option income because the taxpayer did not do any work in New York during that year. Or suppose that 99 percent of the spread was due to the increase in stock price during the December of Year 2, a month when the taxpayer performed no work in New York? Presumably, under *Stuckless*, the taxpayer could argue that he cannot be taxed on 99 percent of the gain because he performed no work in New York in that month. Issues like that promise to be prevalent as a result of the *Stuckless* decision.

5. Exercise After Employment Termination. Many taxpayers who receive stock options from their employers are allowed to exercise them after they retire from employment. In many cases, this is advantageous because the “spread” at retirement may not be significant, and they are given the benefit of post-termination accretions in value. The tribunal made clear in *Stuckless* that the fair-market value of the stock on the date the taxpayer stops working in New York is to be used to determine the gain realized for New York tax purposes:

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

Under this rationale, therefore, a taxpayer who exercises options after terminating employment with a New York employer should be allowed to use the fair-market value of the stock on the date he stopped working in New York as the basis for his New York tax calculation. Any postretirement accretions in value under this theory would not be included when determining the amount of the stock-option income subject to tax.

6. Closely Held Stock. In *Stuckless*, the taxpayer worked for Microsoft. We could determine through a simple Internet search what Microsoft's stock was worth on the day Stuckless left New York. But what if Stuckless worked for a non-publicly-traded company? Presumably, under the tribunal's rationale, Stuckless would be allowed to determine his New York tax based on the value of the stock on the date he left. How he would do that, however, is not as easy a question. Taxpayers under that scenario may find themselves spending time and money determining how best to value their options to obtain the most favorable tax treatment.

7. Other Audit Issues. In addition to the above scenarios, *Stuckless* brings into question the department's ability to mandate the grant-to-exercise method that is laid out in TSB-M-95(3)I. If, as the tribunal held, the use of the memorandum's method is not mandated by *Michaelsen*, and if it does not carry the force of law, two results ensue.

First, *Stuckless* confirms that the department may not enforce the memorandum's grant-to-exercise method as the only manner in which to allocate stock-option income. To do so would be an attempt by the department to enforce the memorandum as a legally binding "rule," which may only be done through a duly promulgated regulation under New York's State Administrative Procedures Act

(SAPA). To enforce a "rule" through an interpretive document, such as a TSB-M, violates the SAPA, and should not be upheld by the courts.

The second result that flows from *Stuckless* is that it may now be permissible for taxpayers to use alternative allocation methods in stock-option cases. Before the memorandum was issued, alternative allocation methodologies were employed in some cases, suggesting — as the tribunal did — that the memorandum might be an incorrect interpretation of existing law.⁵ With no legally binding method out there, taxpayers presumably are now permitted to argue for different and perhaps more favorable tests. Moreover, it seems entirely unreasonable after *Stuckless* for the department to assert penalties based on a taxpayer's failure to follow the TSB-M's grant-to-exercise method.

Conclusion

The tribunal's decision in *Stuckless* provides some vindication for taxpayers and practitioners who, over the years, have argued vehemently against the application of the memorandum by the department in stock-option cases. Given the tribunal's refusal to accept the methodology embodied in the memorandum, it is also sure to have an immediate impact for New York taxpayers. Of course, exactly how the department will react to the decision, and how the issue will play out in different factual circumstances, remains unclear. Stay tuned for further developments. ☆

⁵See *Matter of Christensen*, State Tax Commission (Aug. 22, 1977). *Matter of Tobin*, TSB-H-83(43)I, State Tax Commission (Jan. 24, 1983). *Matter of Sadik-Kahn*, Administrative Law Judge (July 19, 1990).