

Highlighting Multiyear Allocation Difficulties in New York

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In this article, the authors discuss a recently issued New York form for allocating income earned by nonresidents over a multiyear period. Although the form is a welcome improvement, Noonan and Wright note some areas, such as when a taxpayer has multiyear and single-year deferred compensation on the same Form W-2, that the current form still doesn't handle well.

Stop the presses! New York's Tax Department has released a new form — Form IT-203-F — to be used when preparing individual nonresident income tax returns.

What? You were expecting something more exciting?

We admit that such news would not normally justify a Noonan's Note. But for many who practice in this area — and for accountants charged with the difficult task of preparing nonresident New York tax forms — issues surrounding the allocation of income earned by nonresidents over a multiyear period have been a source of significant confusion and controversy over the years. And while the tax department, tax appeals tribunal, and State Legislature have tried to address these issues over the past decade, the tax forms have lagged a bit. This new form, titled "Form IT-203-F, Multi-Year Allocation Form," is designed to catch up to these changes and make it a little bit easier on practitioners preparing nonresident income tax returns — and those like us who often have to defend returns.

So listen up. This is important stuff. The issuance of the form highlights some interesting twists and oddities surrounding New York's rules for allocating compensation earned over multiple years. This applies not just to taxpayers receiving stock option income or termination payments, but also to those taxpayers with any sort of deferred com-

penation, possibly including taxpayers such as hedge fund managers and retired executives.

New York's Rules Regarding Allocation of Multiyear Payments

First, some nuts and bolts about New York's rules in this area — rules that have shifted drastically in the past few years.

For example, as a general matter, it makes sense that an employee who receives compensation for services performed in prior years normally allocates that income based on some calculation designed to reflect where it was earned. But there have been a slew of cases over the past 20 years questioning whether certain types of income paid to taxpayers upon termination of employment (severance pay, contract buy-outs, noncompete payments, etc.) should be allocated just as any other type of wage-based compensation.¹ These cases created lots of fun for practitioners during audits, given the different legal arguments that could be made around the question whether a payment was made for past or future services. It also created lots of planning opportunities for executives on the way out the door because compensation structured as a noncompete payment, for example, was treated more favorably than straight severance.

But in 2010, New York changed its rules regarding the taxation of income received by a nonresident related to a business, trade, profession, or occupation previously carried on within the state. The changes specifically targeted certain termination payments and covenants not to compete.² Though previously such payments were not viewed as being "derived from or connected with New York sources" and were therefore not taxable to nonresidents, the 2010 law subjected this type of income to a potential nonresident allocation.

¹See, e.g., *Matter of McSpadden*, No. 810895, N.Y. Tax App. Trib. (Sept. 15, 1994) (concluding that a lump-sum buyout the taxpayer received from his former employer did not constitute New York source income); *Matter of Haas*, No. 812971, N.Y. Tax App. Trib. (Feb. 1, 1996) and *Matter of Penchuk*, N.Y. Tax App. Trib. (Apr. 24, 1997) (concluding that consideration received by nonresidents for a covenant not to compete with New York companies did not constitute New York source income).

²See Tax Law section 631(b)(1)(F); see also TSB-M-10(9)I (Aug. 31, 2010).

Under the new rules, set forth in a 2010 TSB-M, the sourcing of this type of income was based on the allocation formula for pensions and retirement benefits in New York's regulations (the numerator of which is the total New York source compensation related to the employment previously carried on within New York state during the allocation period, and the denominator of which is the total compensation from that employment includable in federal income for that same period). Moreover, the TSB-M directed that the allocation period set forth in the pension regulation would be used, which looks to the portion of the tax year before the termination of that employment and the three tax years immediately preceding the termination.³

Of course, there was no place on the nonresident tax form to do this sort of nonresident multiyear allocation, hence the creation of Form IT-203-F. But more on that in a second.

The other controversial issue in this area has surrounded the allocation of stock option income, though much of the controversy was put to rest around 2006. Unlike income tied to noncompete agreements or severance agreements, New York has been taxing nonresidents on their New York-connected stock option income and restricted stock income for many years.⁴ But for years there was litigation surrounding how such income should be allocated. New York first published its position in a 1995 TSB-M, suggesting that for most forms of option income, the proper allocation was based on the number of the taxpayer's workdays in New York between the grant and exercise dates.⁵ One taxpayer successfully challenged this TSB-M on retroactivity grounds,⁶ but later the tax appeals tribunal, in *Matter of Stuckless*, voided the method altogether, concluding that the proper nonresident allocation period for stock option income was based on the workday percentage during the year the option was exercised.⁷ But only two short months after *Stuckless*, the Legislature passed N.Y. Tax Law section 631(g), and the tax department published regulations as directed by that law, which effectively overruled *Stuckless* and required that nonresidents allocate stock option income based on the workday allocation formula during the grant-to-vest period.⁸

Since that time, there was some follow-up litigation surrounding whether the *Stuckless* "year-of-exercise" rule

applied to taxpayers no longer working for their employers,⁹ but more or less things have died down in this area. Still, practitioners needing to report this income under the new grant-to-vest rules had a problem: There was nowhere on the old tax form to do so!

Out With the Old and in With the New

So what was the problem with the old form? Before this year, taxpayers had only one option to report the allocation of wage income: Form IT-203-B (the Nonresident Allocation Worksheet). Schedule A of Form IT-203-B provides for a breakdown of the total working days and New York workdays for the tax year at issue and computes a workday allocation percentage for wage and salary income. Unfortunately, the computation on this form is limited to the tax year for which the return is being filed. As a result, taxpayers and return preparers often struggled with how to complete this form when the taxpayer had several different categories of Form W-2 income, some of which had an allocation period that covered more than just the tax year at issue. Many ended up just creating their own new form, attached as a statement to the tax return. Others put together workpapers that were not filed with the return. It often created a mess on audit.

The form will continue to be the correct form to use for the allocation of certain W-2 compensation (for example, salary or bonus income) subject to allocation based on the current tax year. But beginning in tax year 2014, taxpayers and practitioners will use the new Form IT-203-F to do a multiyear allocation for the types of income discussed above. For example, Schedule A of this new form will be used to allocate income attributable to past employment in New York state. As noted above, the department takes the position that this type of income is subject to a four-year allocation period (the portion of the tax year before termination plus the three tax years immediately preceding the year of termination). As a result, the new form allows taxpayers to spell out the type of income they are allocating (for example, termination pay) and the exact period the allocation covers, calculate a New York allocation percentage by blending the allocation percentages from each of the four tax years covered by the allocation period, and apply that blended allocation percentage to the income received in the current tax year.

Schedule B of the new form will be used for allocation of stock options, restricted stock, and stock appreciation rights. The new form asks taxpayers to describe the stock they are allocating (for example, 100 shares of XYZ Corp.) and list the grant date, vest date, and exercise date for each

³TSB-M-10(9)I; see also 20 NYCRR section 132.20.

⁴See TSB-M-07(7)I (Oct. 4, 2007).

⁵TSB-M-95(3)I (Nov. 21, 1995).

⁶*Matter of Rawl*, No. 813892, N.Y. Div. Tax App. (Dec. 10, 1998).

⁷*Matter of Stuckless*, No. 819319, N.Y. Tax App. Trib. (May 12, 2005).

⁸For more details on the *Stuckless* saga, see Timothy P. Noonan and Jack Trachtenberg, "Stock Options — The New York Tax Department's Effort to Undermine *Stuckless*?" *State Tax Notes*, Apr. 23, 2007, p. 279.

⁹See *Matter of Abodeely*, Nos. 821863, 821939, N.Y. Div. Tax App. (Jan. 29, 2009); *Matter of Hopkins*, No. 821812, N.Y. Div. Tax App. (Jan. 8, 2009).

option, stock, or right.¹⁰ Taxpayers will then mark a box regarding the type of stock at issue: statutory option, non-statutory option, restricted stock, or stock appreciation rights. The type of stock will determine the appropriate allocation period (found in the Schedule B table on the IT-203-F instructions).¹¹ Once the appropriate allocation period is identified, taxpayers will enter the relevant column A and column B amounts from the Schedule B table to determine the amount of income to be allocated.¹² Finally, taxpayers will calculate a New York workday allocation percentage for the allocation period at issue and multiply that allocation percentage by the relevant stock option income to determine the amount of New York source income to be reported on the nonresident return.

Comments

I know, you're dying to know what we think about this new form.

No doubt, this is a definite improvement over the imperfect W-2 allocations that often resulted from the one-size-does-not-fit-all IT-203-B. Laws in this area have changed, and it's important that the forms keep pace — kudos to the department for issuing this. It should help all around.

That said, nobody's perfect. There are still some components of income that may be searching for a home on a tax form. For instance, many taxpayers receive different forms of compensation on one W-2 (that is, salary, bonus, termination pay, deferred compensation, stock option, etc.). And though the new form is designed to address income received over multiyear periods, sometimes an employee receives a deferred income relative to just one prior period, such as a bonus received in 2014 for work performed in 2013. There isn't a clear way for a taxpayer to report this income because the IT-203-B is designed to reflect current-year allocation, and the IT-203-F explicitly refers to a multiyear allocation. The fix is probably to use the IT-203-F and show the allocation period as one calendar year. That should do the trick, but there still will be situations in which the practitioner will have to get a little creative in figuring out where to show certain types of income.

What is most interesting, though, is that this form highlights a potential area of dispute relative to the allocation

method for termination-type income earned over several prior tax years. Consider the following example: A nonresident taxpayer receives a \$10 million termination payment in 2014. Also assume that this taxpayer worked for a Texas company but was often required to come to New York for work purposes depending on company projects or issues. According to the 2010 TSB-M issued by the department after the Legislature enacted Tax Law section 631(b)(1)(F), this taxpayer is supposed to compute his allocation based on a fraction, the numerator of which is the amount of compensation included in his New York-source income over the previous four years and the denominator of which would simply be total compensation. This calculation would be set forth in a table on the IT-203-F and for this taxpayer would look like this:

Tax Year	A- Total Compensation	B- New York Amounts
2010	\$10	\$8
2011	\$2	0
2012	\$4	\$2
2013	\$4	\$2
Total	\$20	\$12

Based on these amounts, the allocation formula prescribed by the form would be 60 percent (\$12 million/\$20 million). Thus, 60 percent of the taxpayer's \$10 million termination payment would be allocated to New York.

But is that actually the proper way to compute the allocation on this payment? This four-year compensation-to-compensation method is the approach taken under 20 NYCRR section 132.20, a section of the regulations applicable to pensions and other retirement benefits. But the law does not explicitly prescribe this method; it merely instructs taxpayers to compute a multiyear allocation based on New York's regulations. Those regulations, however, do not actually contain any guidance to taxpayers on how to allocate termination payments, noncompete payments, or similar-type income.

Given that, might a taxpayer be able to argue that the allocation formula is more appropriately determined based on the year the income is paid? Certainly that was the lesson from the *Stuckless* litigation — that when the regulations do not explicitly create an allocation method, the proper allocation method is based on the year the income was earned. Here, as in *Stuckless*, the department appears to be basing its method, however reasonable, on a TSB-M. But without regulatory support for this multiyear method, the approach outlined on the new form and in the TSB-M may be subject to challenge.

Also, even if a taxpayer conceded to a multiyear allocation in this instance, is the compensation-to-compensation

¹⁰Note that if the grant and vest dates are the same, the allocation percentage used for such stock income/rights is the same percentage computed on the Form IT-203-B for the tax year the option or right was granted.

¹¹See IT-203-F instructions, at 4. This schedule provides the proper allocation period to be used for each relevant type of stock income: statutory and nonstatutory stock options, restricted stock, and stock appreciation rights.

¹²For nonstatutory stock options with no readily ascertainable fair market value at the time of the grant, for instance, taxpayers will determine the difference between the FMV on the exercise date and the grant price for the stock options at issue to determine the amount of income to be allocated.

method more accurate than looking to the taxpayer's workdays over the period the income was earned, similar to the rules clearly outlined in the stock option area? One might wonder whether this makes a difference, but from the example above, it could make a significant difference, particularly in cases in which a taxpayer's compensation and New York presence vary from year to year. To illustrate this, Table 2 shows how our hypothetical taxpayer's allocation formula would look if we used workdays in prior periods instead of compensation amounts in prior periods to determine the allocation percentage.

Tax Year	Total NY Workdays	Total Workdays
2010	160	200
2011	0	200
2012	100	200
2013	100	200
Total	360	800

Using this method, the taxpayer's allocation method is 45 percent (360/800), or 15 percent lower than determined under the compensation-to-compensation method. If the termination payment was \$10 million, this would create a difference in New York tax close to \$150,000.

I suppose the department would likely take the position that its compensation-to-compensation method here is reasonable because it is based on the method outlined for the

taxation of pensions or other retirement benefits. But the department made similar assumptions about the reasonableness of its allocation methods in the old stock option litigation, and the result turned out quite differently.

So while this new tax form absolutely is an improvement over the past, it does highlight this interesting and novel issue that I suspect we may see play out in future cases.

A Final Note About Retirement Income

Sometimes compensation that comes in the form of multiyear payments is not subject to a nonresident allocation at all. As we've discussed in prior columns, some types of retirement income earned by nonresidents are exempt from state taxation.¹³ For instance, a nonresident's income from a nonqualified deferred compensation plan may be exempt from taxation by New York state if it falls within the retirement income exemption under 4 U.S.C. section 114(a). Practitioners should keep an eye out for this type (and other types) of retirement income that falls within the federal exemption. We regularly run into cases in which employers have continued to withhold New York income tax on these payments if they aren't made aware that former employees have become nonresidents of New York. ☆

¹³See Timothy P. Noonan and Ryan M. Murphy, "What Retirement Income Is Exempt From State Taxes?" *State Tax Notes*, June 11, 2012, p. 781.