

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

This memorandum provides guidance on the New York tax treatment of stock options, restricted stock and stock appreciation rights received by nonresidents or part-year residents who are or were employed in New York State. This memorandum explains the tax treatment of income, gain or loss attributable to these items for nonresidents and part-year residents of New York State. Also included is an explanation of the tax treatment of these items under the New York City and Yonkers nonresident earnings taxes.

Nonresidents

Statutory Stock Options

This section deals with statutory options within the meaning of section 421 of the Internal Revenue Code (IRC).

The New York State Court of Appeals ruled, in *Michaelson v. The New York State Tax Commission*, 67 N.Y. 2d 579 (July 8, 1986), 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.

The court further held that, although the compensation element of an incentive stock option is realized on the date the option is exercised, the compensation amount is not taxable for New York State purposes until the income or gain is recognized for federal income tax purposes upon the sale of the stock. If the stock has been held for the required holding period to qualify as a long-term capital gain, the entire gain (both the gain related to the exercise of the option and the gain attributable to the appreciation in the value of the stock after the date of exercise) is treated as capital gain for federal and state income tax purposes.

However, the court stated that this capital gain treatment does not mean that the employee did not realize compensation at the time of exercise, but merely that the compensation, when later recognized, is recognized as capital gain. Accordingly, the amount of capital gain that represents the compensation element is considered gain derived from New York State sources and is subject to New York State tax when recognized for federal income tax purposes.

Note: For purposes of determining the amount of compensation under the above rules, options that are redeemed or canceled in exchange for cash or property are treated as if they had been exercised on the date of the redemption or cancellation.

Although Michaelson resolved the issue concerning the total compensation that may be includable in the New York source income¹ of a nonresident, the court did not address how the total amount should be allocated for New York purposes if the employee performs (or performed) services both inside and outside the state. Since the court determined that compensation constitutes the appreciation in the value of the stock from the date of grant to the date of exercise, that period is considered the period over which the employee's performance of services will be measured (compensable period).

Therefore, based upon sections 132.4(c) and 132.18 of the Personal Income Tax Regulations, it is the Tax Department's position that any allocation must be based on the allocation applicable to regular (non-option) compensation received by the employee during the compensable period. The allocation is computed by multiplying the compensation attributable to the option by a fraction whose numerator is the total days worked by the employee inside New York State during the compensable period, and whose denominator is the total days worked by the employee both inside and outside the state during the compensable period. However, if an employee exercises an option after terminating employment with the employer who granted the option, the compensable period, and therefore the allocation, is limited to the days worked inside and outside the state during the period from the date of grant to the date employment ceases.

¹ New York source income is the numerator of the fraction used to compute the income percentage. The denominator of the income percentage is the taxpayer's New York adjusted gross income, computed as if the taxpayer were a resident. The income percentage is applied to the taxpayer's tax, computed as if a resident, to determine the New York State tax.

Example 1: Ray Brown, a nonresident, performs services both inside and outside New York State for the XYZ corporation. On August 1, 1989, Ray was granted incentive stock options to purchase 5,000 shares of XYZ stock for \$30 per share. On July 1, 1990, when the fair market value of the stock was \$40 per share, he exercised the options and purchased the stock for \$150,000. On September 30, 1994, Ray sold the stock for \$55 per share and received \$275,000. He recognized long-term capital gain for federal income tax purposes of \$125,000 [sales price (\$275,000) less cost (\$150,000)].

During the compensable period, beginning on the grant date (8/1/89) and ending on the exercise date (7/1/90), Ray worked a total of 210 days, 126 of which were worked in New York State. The amount of gain includable in Ray's 1994 New York adjusted gross income, computed as if a resident, is \$125,000. The amount of gain includable in his 1994 New York source income is computed as follows:

Fair market value of stock	
on exercise date.....	(5,000 shares X \$40) = \$ 200,000
Less: Option price of stock.....	(5,000 shares X \$30) = <u>150,000</u>
Amount of federal capital gain treated as compensation	\$ 50,000

Allocation applicable to regular compensation
for the compensable period:

Days worked in New York = $\frac{126}{210} = 60\%$	<u> </u> X .60
Total days worked	210

Gain includable in New York source income.....\$ 30,000

Note: Even though the \$30,000 capital gain is treated as compensation for New York purposes, it is still reported as long-term capital gain on Ray's New York State nonresident return. However, if in this example, Ray had not held the stock for the required holding period to qualify as a long-term capital gain, the \$30,000 would be reported as ordinary income on his New York return.

If stock acquired through an option is subsequently sold for less than its fair market value at the time the option was exercised, compensation for New York purposes is limited to the amount of gain actually recognized. This is the case even though the taxpayer may have been deemed to have realized a higher amount of compensation for New York purposes at the time of exercise. However, if the stock is sold for less than the option price, no compensation is recognized and the resulting

federal capital loss is not allowable in computing New York source income.

Example 2: Bob Smith, a nonresident, was granted incentive options to purchase his employer's stock at \$20 per share. He exercised the options when the fair market value was \$35 per share, thus realizing compensation of \$15 per share. However, Bob subsequently sold the stock for \$30 per share, thus recognizing a capital gain of only \$10 per share. The amount Bob has to treat as compensation for New York purposes is limited to \$10 per share, which would then be subject to any allocation as previously described.

Example 3: Assume the same facts as example 2, except that Bob sold the stock for \$15 per share, recognizing a capital loss of \$5 per share. In this instance, Bob does not recognize any compensation for New York purposes, and no part of the capital loss would be allowed in computing his New York source income.

Restricted Stock Plans

This section deals with restricted stock within the meaning of section 83 of the IRC.

In general, the value of stock or other property, except for statutory stock options, received by an employee in connection with the performance of services is taxable as compensation for federal income tax purposes in the year the rights of the employee having the beneficial interest in the property are transferable or are not subject to substantial risk of forfeiture (i.e., vested). However, if the employee makes the election under section 83(b) of the Internal Revenue Code [section 83(b) election], the value is taxable in the year the property is received. Furthermore, if the section 83(b) election is not made and the property is subsequently sold or otherwise disposed of in an arm's length transaction while still substantially nonvested in the employee, 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 for federal and New York purposes is the difference between the fair market value of the stock at the time the stock vests and the amount, if any, paid for the stock by the employee. However, if the stock is sold before it vests, compensation is the difference between the amount realized on the sale and the amount paid, if any, for the stock by the employee.

The federal compensation amount is to be allocated to New York based upon the allocation applicable to regular (non-stock) compensation received by the employee for the period beginning with the date the stock is received and ending on the earlier of the date it vests, the date the employee's services terminate, or the date the stock is sold.

In addition, dividends received on the stock before it vests are also considered compensation for federal and New York State purposes. The amount of this compensation that is includable in New York source income is computed by using the allocation applicable to regular (non-stock) compensation for the entire tax year during which the dividends were declared. For example, dividends declared in 1994 but not paid until 1995 would be includable in the taxpayer's 1995 New York source income using the 1994 allocation percentage.

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

Compensation for federal and New York purposes is the difference between the fair market value of the stock on the date it is received and the amount paid for the stock by the employee.

The compensation amount is allocated to New York based upon the allocation applicable to regular (non-stock) compensation for the entire tax year during which the stock is received. However, in certain cases, the taxpayer may be required to use the alternate allocation percentage. (See Alternate Allocation for Restricted Stock and Nonstatutory Stock Options on page 8).

Dividends received on restricted stock where the section 83(b) election has been made are investment income that is not taxable to a nonresident.

Example 4: On July 1, 1989, ABC corporation sells to Mary Smith, a nonresident, 200 shares of ABC stock for \$20 per share. At the time of the sale, the fair market value of the stock was \$50. Under the terms of the sale, Mary must forfeit the stock if she does not remain employed by ABC for the next five years. She does not make the section 83(b) election for federal income tax purposes. Mary fulfills the terms, and on July 1, 1994, the stock becomes vested. At this time, the stock has a fair market value of \$75.

Mary worked inside and outside New York State between July 1, 1989, and July 1, 1994. During that period, 60% of Mary's work days were in New York State. The amount of compensation includable in Mary's 1994 New York adjusted gross income, computed as if a resident, is \$11,000. The amount includable in her 1994 New York source income is computed as follows:

Fair market value of stock	
when vested.....	200 shares X \$75 = \$15,000
Less: amount paid for stock.....	200 shares X \$20 = <u>4,000</u>
Compensation recognized for federal and New York	
Income tax purposes.....	\$11,000
 New York allocation for period 7/1/89 - 7/1/94.....	<u>X .60</u>
 Compensation includable in New York source income.....	<u>\$ 6,600</u>

Any further appreciation or depreciation in the value of the stock and any dividends attributable to the stock after July 1, 1994, are not compensation for federal or state income tax purposes. Accordingly, if these amounts are recognized for federal income tax purposes at a time when Mary is a nonresident, they would not be includable in Mary's New York source income.

Example 5: On August 1, 1994, XYZ corporation sells to John Jones, a nonresident, 300 shares of XYZ stock for \$25 per share. At the time of the sale, the fair market value of the stock was \$60 per share. John makes the section 83(b) election for federal income tax purposes. For the entire 1994 tax year, 40% of John's work days were in New York State. The amount of compensation includable in John's 1994 New York adjusted gross income, computed as if a resident, is \$10,500. The amount includable in his 1994 New York source income would be computed as follows:

Fair market value of stock	
at time of sale.....	300 shares X \$60 = \$18,000
Less: amount paid for stock.....	300 shares X \$25 = <u>7,500</u>
Compensation recognized for federal and New York State	
income tax purposes.....	\$10,500
 New York allocation percentage for 1994.....	<u>X .40</u>
 Compensation includable in New York source income.....	<u>\$ 4,200</u>

Any further appreciation or depreciation in the value of the stock and any dividends attributable to the stock after August 1, 1994 are not considered compensation for federal or state purposes. Accordingly, if these amounts are recognized for federal purposes at a time when John is a nonresident, they would not be includable in John's New York source income.

Stock Appreciation Rights

A stock appreciation right entitles a corporate employee to a cash payment. This cash payment is equal to the fair market value of the corporation's stock on the date the appreciation right was exercised less the fair market value of the stock on the date the appreciation right was granted. This amount represents compensation for federal and New York income tax purposes and is subject to tax in the year the appreciation right is exercised.

Since, as in the case of statutory stock options, the appreciation in the value of the underlying stock from the date of grant to the date of exercise constitutes compensation, the amount includable in New York source income must also be based on that period. See *Statutory Stock Options* on page 1 for the method of computing the amount of compensation includable in New York source income.

Nonstatutory Stock Options

If a nonstatutory stock option has a readily ascertainable fair market value at the time of grant, compensation for federal and New York purposes is equal to the fair market value of the option at the time of grant less any amount paid for the option. The amount of compensation includable in New York source income is computed using the allocation applicable to regular compensation in the year the option is granted. However, the taxpayer may be required to use the alternate allocation. See *Alternate Allocation for Restricted Stock and Nonstatutory Stock Options* on page 8.

If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, compensation for federal and New York purposes 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. Therefore, as in the case of statutory stock options, the amount of compensation includable in New York source income is generally computed using the allocation applicable to regular compensation received by the employee from the date of grant to the date of exercise. See *Statutory Stock Options* on page 1 for detailed rules and methods for computing the allocation. However, unlike statutory stock

options, compensation for these options is recognized for federal and state income tax purposes at the time of exercise and is therefore not dependent upon the subsequent selling price of the stock. Accordingly, any further appreciation or depreciation in the value of the stock after the date of exercise represents investment income or loss not includable in the New York source income of a nonresident.

Alternate Allocation for Restricted Stock and Nonstatutory Stock Options

As previously explained, if an employee receives restricted stock and makes the section 83(b) election, or an employee receives nonstatutory stock options with a readily ascertainable fair market value, the compensation is taxed for federal and New York State purposes in the year of receipt. In these cases, the amount includable in New York source income is generally computed using the allocation applicable to regular compensation for the year of receipt.

However, there may be instances where the compensation attributable to the stock or option is in fact attributable to a prior tax year or years. For example, an employer grants nonstatutory stock options with a readily ascertainable fair market value to an employee in 1994 as a bonus for attaining a certain level of performance in 1993. In this case, the compensation is attributable to services performed in 1993. Accordingly, the amount of compensation includable in a nonresident employee's 1994 New York source income must be computed using the allocation that applied to the employee's 1993 regular compensation.

Nonresident employees who qualify to use an alternate allocation method must attach to their nonresident return a full explanation of why that method is being used. The burden of proof is upon the employee to establish that an alternate method is proper.

Part-Year Residents

If a taxpayer has a change of New York resident status during the year, the following special rules are used to compute the amount of compensation attributable to stock and options that is includable in New York source income. These rules also apply for determining the period (resident or nonresident) in which the compensation should be reported if a taxpayer has a change of resident status for New York City or Yonkers tax purposes. However, see *City of New York and City of Yonkers Nonresident Earnings Taxes* on page 10 if any of the amount is properly reportable in the city nonresident period.

Statutory Stock Options

As previously indicated, the amount of compensation attributable to statutory stock options is recognized when the stock is sold and therefore it may be dependent upon the selling price of the stock. Accordingly, the amount of compensation realized (but not recognized) upon exercise is not an accruable item under section 639 of the Tax Law when a taxpayer has a change of resident status. For more information on the special accrual rules, see TSB-M-94-(9)I. Therefore, the New York tax treatment of the gain or loss when it is recognized for federal income tax purposes is dependent on the taxpayer's resident status at the time of the sale.

If the stock is sold during a resident period, the entire 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 adjusted gross income, computed as if a resident, and New York source income. If the stock is sold during a nonresident period the entire federal gain or loss is also included in New York adjusted gross income, computed as if a resident. However, the amount of any gain² includable in New York source income is limited to the compensation element, and any allocation is based upon days worked inside and outside the state determined as if the taxpayer were a nonresident from the time the option was granted until it was exercised or employment terminated.

Example 6: Sandy Small was granted statutory stock options on August 1, 1990, when she was a New York State resident. On April 1, 1993, while still a resident, she exercised the options and realized compensation in the amount of \$2,000.

On October 1, 1993, she changed her resident status from New York to Connecticut. On June 1, 1994, while still a Connecticut resident, she sold the stock, recognizing a capital gain for federal income tax purposes of \$3,000. The \$3,000 capital gain is therefore includable in her New York adjusted gross income, computed as if a resident. However, since she was a

² As previously explained, any loss on the sale of the stock is not includable in the New York source income of a nonresident. In addition, a loss is not includable in the New York source income of a part-year resident for the nonresident period.

nonresident at the time of the sale, she uses the nonresident rules to determine the amount of the federal capital gain includable in her 1994 New York source income. This is true even though \$2,000 of the capital gain is attributable to the compensation element realized, but not recognized, at the time she was a resident.

During the period August 1, 1990 - April 1, 1993, Sandy worked inside and outside New York State. Using nonresident rules, Sandy determines that 75% of the days she worked during the above period were worked in New York State. Accordingly, Sandy must include in her 1994 New York source income \$1,500 of the capital gain (75% of the compensation portion (\$2,000) of the federal capital gain.)

Restricted Stock and Nonstatutory Stock Options

As in the case of statutory options, the amount of compensation related to restricted stock and nonstatutory options includable in New York source income is dependent upon the individual's resident status at the time the compensation is recognized for federal tax purposes. Furthermore, if the taxpayer changed resident status from resident to nonresident and the compensation is recognized in the nonresident period, the amount includable in New York source income is computed as if the taxpayer were a nonresident for the entire allocation period. The allocation period for restricted stock where the section 83(b) election is not made is from the date the stock is received to the earlier of the date it vests, the employee's services are terminated, or the stock is sold. The allocation period for nonstatutory options without an ascertainable fair market value is from the date of grant to the earlier of the date of exercise or the date the employee's services terminate. In the case of restricted stock where the section 83(b) election is made, or for options with a readily ascertainable fair market value, the allocation period is the year in which the stock or options are received, unless the alternate allocation applies.

City of New York and City of Yonkers Nonresident Earnings Taxes

The City of New York and City of Yonkers nonresident earnings taxes are imposed on an employee's wages, as defined in section 3401 of the Internal Revenue Code, earned inside New York City

or Yonkers, respectively.³ Section 3401 of the Internal Revenue Code defines wages subject to withholding for federal income tax purposes.

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

In the case of restricted stock, stock appreciation rights, and nonstatutory stock options, compensation recognized for federal income tax purposes does constitute wages under section 3401. Accordingly, compensation related to these items would be includable in taxable wages subject to the New York City or Yonkers nonresident earnings taxes if the employee performed services in either or both cities.

If the taxpayer performed services both inside and outside either city, the compensation is allocated to the applicable city using the same rules and allocation periods that apply to nonresidents of New York State. However, the days worked inside and outside the city would be used in place of the days worked inside and outside the state.

³ The nonresident earnings taxes are also imposed on certain other items (not relative to the issues addressed in this memorandum) that are not defined as wages under section 3401.