

# STATE TAX CONSIDERATIONS FOR STOCK PLAN PROFESSIONALS

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# STATE TAX CONSIDERATIONS FOR STOCK PLAN PROFESSIONALS

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Over the past several years, much has been said and written about the international aspects of equity compensation. Yet, equally complex and perhaps even more pervasive are the U.S. multi-state tax aspects of equity compensation, about which relatively little has been said or written. This outline provides an overview of how stock options are taxed at the state level. It then covers some of the more intricate and interesting state tax aspects of stock options, including the potential double taxation of optionees and some of the withholding and apportionment issues encountered by employers. It also covers selected peculiarities that arise in specific states.

## **I. State Taxation of Optionee**

### **A. State Tax Treatment of Stock Options Based on Federal Tax Treatment**

1. Most states follow the federal income tax treatment of stock options.
2. For federal tax purposes, nonstatutory stock options (“NSOs”) are taxed as follows (assuming the options do not have a readily ascertainable fair market value).
  - a. An optionee recognizes no income upon the grant of an NSO.
  - b. An optionee recognizes compensation income upon the exercise of an NSO equal to the value, on the exercise date, of the stock acquired less the exercise price (the “spread”).
  - c. An optionee recognizes capital gain or loss upon the sale of the stock acquired upon exercise of an NSO equal to the difference between the sales proceeds and the value of the stock on the exercise date.
3. For federal tax purposes, incentive stock options (“ISOs”) are taxed as follows.
  - a. An optionee recognizes no income upon the grant or the exercise of an ISO.

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- b. However, an optionee recognizes income for alternative minimum tax (“AMT”) purposes upon the exercise of an ISO equal to the spread on the exercise date.
- c. An optionee recognizes capital gain or loss upon a qualifying disposition of the stock acquired upon exercise of an ISO equal to the difference between the sales proceeds and the exercise price. A qualifying disposition is a sale more than two years after the ISO was granted and more than one year after the optionee exercised the ISO.
- d. An optionee generally recognizes compensation income upon a disqualifying disposition (a sale that does not meet the holding period requirements for a qualifying disposition) of the stock acquired upon exercise of an ISO equal to the lesser of:
  - (i) The spread on the exercise date, and
  - (ii) The optionee’s profit (*i.e.*, the amount by which sales proceeds exceeds exercise price).

Any profit in excess of the compensation income is recognized by the optionee as capital gain. Any loss (*i.e.*, the amount by which sales proceeds are less than exercise price) recognized by the optionee is a capital loss.

- 4. This outline assumes that all NSOs are granted with an exercise price equal to fair market value, are exercisable for common stock, and do not otherwise have a deferral feature. Therefore, such NSOs are assumed to be exempt from Section 409A of the Internal Revenue Code.
  - a. If an NSO is not exempt from, or compliant with, Section 409A, the optionee will be subject to current income inclusion, an interest charge, and a 20% penalty tax for federal income tax purposes.
  - b. Presumably, most states will follow the federal tax treatment and require current income inclusion. In addition to requiring current income inclusion, California imposes an additional interest charge and 20% penalty tax. We are not aware of any other state that imposes an additional interest charge or penalty tax.
- 5. Some states, such as Pennsylvania, Hawaii and Rhode Island, do not always follow the federal tax treatment of stock options.
  - a. Pennsylvania taxes ISOs in the same manner as NSOs, taxing the spread on the exercise date as compensation income at the time of exercise. *See 61 Pa. Code § 101.6(f)*. This could result in double taxation of an optionee in certain circumstances. See Example 12.

- b. Hawaii does not tax income recognized by an employee from stock options granted by a qualified high technology business or a holding company of a qualified high technology business. A qualified high technology business generally is one that conducts 50% or more of its activities in qualified research activities, which includes research in certain computer software, biotechnology, sensor and optic technologies, ocean sciences, and astronomy. The relevant statute contains a complete list of qualified research activities. *See Haw. Rev. Stat. § 235-7.3, 235-9.5.*
- c. Rhode Island does not tax income from stock options granted by qualifying corporations to Rhode Island resident employees. A qualifying corporation generally is a corporation engaged in computer programming services, prepackaged software design, or computer-integrated systems design, that has more than 10 full-time employees in Rhode Island, and that has annually elected the special treatment. *See R.I. Gen. Laws §§ 44-39.3-1, 44-39.3-3.* Rhode Island also has a small business tax incentive under which income from stock options granted by expanding, publicly-traded companies headquartered in Rhode Island may be excluded from income. *See R.I. Gen. Laws § 44-43-8.*

## **B. Tax Treatment in Optionee's State of Residence**

1. States tax their residents on all of their income regardless of its source.
  - a. The term "resident" generally refers to any individual domiciled in the state.
    - (i) A person's domicile is where the person has his or her permanent home, and is often referred to as the place to which the person intends to return whenever absent.
    - (ii) The term "resident" may also include a person who maintains a permanent place of abode within the state and/or who spends a specified period of time (generally, more than 183 days) during the taxable year in the state.
  - b. A person may be a resident of more than one state, although that is not typically the case.
2. Generally, income recognized by an optionee upon the exercise of a stock option and upon the sale of stock acquired upon exercise will be taxed by the optionee's state of residence at the time of the exercise and the sale.

Example 1: Tom, a resident of Massachusetts, exercises an NSO on May 1, 2006 and purchases 10 shares of stock, with a value of \$10 per share, for \$1 per share. On June 30, 2007, Tom sells the stock for \$15 per share. Tom received the NSO from a company for which he performed services solely in Massachusetts.

Tom recognizes \$90 of compensation income upon exercise of the NSO, all of which is taxed by Massachusetts.

Tom recognizes \$50 of long-term capital gain upon the sale of the stock, all of which is taxed by Massachusetts.

### **C. Tax Treatment in State Where Optionee Performs Services**

1. States tax nonresidents only on their income from sources within the state.
  - a. Income from sources within a state generally include, among other things, income derived from or connected with:
    - (i) Any trade, business, or occupation (including any employment) carried on by the nonresident in the state, whether or not the nonresident is actively engaged in a trade, business, or occupation in the state in the year in which the income is received; and
    - (ii) The ownership of any interest in real or tangible personal property in the state.
  - b. States generally do not tax nonresidents on income derived from or connected with the ownership of an interest in intangible personal property (such as stock) unless the property is used in a trade or business in the state or has acquired a business situs in the state.
2. Generally, compensation income recognized by an optionee with respect to a stock option will also be taxed by the state in which the optionee performed the services that generated the income, regardless of whether the optionee is a resident of the state.
  - a. Many states have not specifically addressed how compensation income of a nonresident from a stock option is taxed. Presumably, however, these states will assert their jurisdiction to tax the compensation income of a

nonresident if the services that generated the income were performed in the state.

- b. Minnesota, however, has determined that if compensation income from stock options is recognized in a year when the optionee is a nonresident of Minnesota for the entire year, none of the income is allocable to Minnesota, even where the services that generated the income were performed in Minnesota. *See Minn. Rev. Notice 01-10.*
3. A tax credit may be available in the optionee's state of residence or in the state in which the optionee performs services, as discussed in Section I., E., to avoid double taxation by the states.

Example 2: Same facts as Example 1, but Tom received the NSO from a company for which he performed services in Rhode Island from the grant date of the NSO to the exercise date. During that period, Tom performed no services in Massachusetts. Assume that the NSO does not qualify for special tax treatment in Rhode Island, as discussed above.

Tom recognizes \$90 of compensation income upon exercise of the NSO, all of which is taxed by Rhode Island because all of the services that generated the income were performed in Rhode Island, and all of which is taxed by Massachusetts because Tom is a resident of Massachusetts.

Tom recognizes \$50 of long-term capital gain upon the sale of the stock, all of which is taxed by Massachusetts, Tom's state of residence, but none of which is taxed by Rhode Island because the income is not from sources within Rhode Island.

Example 3: On May 28, 2004, while he was a resident of California, Matt was granted an ISO for 20 shares of stock with an exercise price of \$5 per share. On May 28, 2006, the ISO vested, and Matt exercised the ISO. The fair market value of the stock was \$50 per share. Matt then retired and moved to Arizona. On April 1, 2007, Matt sold the stock acquired upon exercise of the ISO for \$100 per share. From the grant date of the ISO through the exercise date, Matt only performed services in California for the company that granted him the ISO.

Matt recognizes \$900 of compensation income upon the sale of the stock because the sale is a disqualifying disposition. All of the compensation income is taxed by Arizona, Matt's state of residence at the time of the sale. *See Ariz. Dept. of Rev. Individual Income Tax Ruling 02-5, (Oct. 21, 2002) ["AZ ITR 02-5"]*.

Matt recognizes \$1,000 of short-term capital gain upon the sale of the stock, all of which is taxed by Arizona, Matt's state of residence at the time of the sale, but none of which is taxed by California because the income is not from sources within California. *See AZ ITR 02-5; Ca. Franchise Tax Board Pub. 1004 (Oct. 2007) ["CA FTB Pub. 1004"]*.

The \$900 of compensation income recognized upon the sale of the stock is also taxable in California because all of the services that generated the income were performed in California (*i.e.*, Matt only performed services in California from the grant date through the exercise date of the option). See Section I., G. below for a discussion regarding the AMT adjustment upon exercise of the ISO for California tax purposes. *See CA FTB Pub. 1004*.

#### **D. Allocation of Compensation Income When Optionee Performs Services in More Than One State**

1. If an optionee performs services in more than one state during the period from the grant date of a stock option to the exercise date, the optionee generally must allocate the compensation income from the stock option among those states. Compensation income allocable to a state in which the optionee is a

nonresident will be taxable in that state. All compensation income is taxable in the optionee's state of residence, regardless of where the services that generated the income were performed.

2. Generally, compensation income is allocated to a state to the extent that the income is reasonably attributable to services performed in the state.
  - a. Although most states have addressed how compensation income generally is allocated to a state, many states have not addressed the specific issue of how compensation income generated from stock options is allocated.
    - (i) When an employee works for an employer in multiple states during a year, many states allocate the compensation income received from the employer during the year based upon the time worked, where the allocation ratio equals the number of days worked during the year in the state divided by the number of total days worked during the year.
    - (ii) Income from stock options is generally recognized in the year of exercise, in the case of NSOs, or the year of sale, in the case of ISOs (although the compensation income attributable to ISOs is generally determined as of the time of exercise).
    - (iii) Therefore, under the general allocation rules of many states, income from stock options may be allocated based on the number of days worked in the state during the year of exercise.
      1. In Matter of Stuckless, DTA No. 819319 (N.Y. Tax Tribunal, Aug. 17, 2006), the New York Tax Appeals Tribunal determined that the proper method of allocation for stock option income was the number of days worked in New York during the year of the exercise of the option. The New York State Department of Taxation and Finance had previously taken the position that the proper method of allocation was the number of days worked in New York during the period from the grant date of the option to the exercise date. *N.Y. Dept. of Taxation and Finance Memo., New York Tax Treatment of Stock Options, Restricted Stock and Stock Appreciation Rights, Received by Nonresidents and Part-Year Residents, TSB-M-95(3)(I) (Nov. 21, 1995) ["TSB-M-95(3)(I)"]*. The Tribunal determined that this method was not supported by existing regulations.
  - b. Some states have addressed the specific issue of how compensation income generated from stock options is allocated. Because income from stock options is often attributable to services performed prior to the year of exercise, those states have determined that the allocation period is not the year of exercise.



- (i) Many of these states have determined that the allocation period is the period from the grant date of the option to the exercise date.
1. The New York Tax Appeals Tribunal’s decision in Matter of Stuckless may call into question whether this methodology is supported by the law in such states. Often the allocation methodology is not addressed by regulation but a publication or ruling.
  2. Some of these states provide that the allocation period will be the period from the grant date of the option to the date of the optionee’s termination of employment (if earlier than the exercise date). *See CA FTB Pub. 1004; AZ ITR 02-5*. Without such a rule, the allocation could be distorted (unless the state limits the work days included in the allocation to those for which the optionee performed services for the grantor of the option). See Example 6.
  3. The following table provides a list of those states for which we found authority indicating they have adopted this allocation period.

<i>State</i>	<i>Authority</i>
Arizona	<i>AZ ITR 02-5</i>
California	<i>CA FTB Pub. 1004</i>
Connecticut	<i>Conn. Agencies Regs. § 12-711(b)-(16),(18)</i>
Maine	<i>18-125 Me. Code R. § 806</i>
Massachusetts	<i>830 Mass. Code Regs. 62.5A.1(3)(c)(2)</i>
Oregon	<i>Or. Admin. R. 150-316.127-(A)(3)(d)(B)</i>
Virginia	<i>Va. Dept. of Taxation, P.D. 05-32 (Mar. 15, 2005)</i>

- (ii) Some of these states have determined that the allocation period is the period from the grant date of the option to the vesting date.
1. After the New York Tax Appeals Tribunal’s decision in Matter of Stuckless, the New York State Department of Taxation and Finance promulgated regulations providing for allocation based on the period from the grant date of the option to the vesting date. *N.Y. Personal Income Tax Regs. § 132.24. See also N.Y. Dept. of Taxation and Finance Memo., New York Tax Treatment of Stock Options, Restricted Stock and Stock Appreciation Rights, Received by Nonresidents and Part-Year Residents, TSB-M-07(7)(I) (Oct. 4, 2007) [“TSB-M-07(7)(I)”].*

2. Idaho also provides for an allocation period from the grant date to the vesting date (or the date the employee's services terminated, if earlier) rather than the exercise date. *See Idaho Admin. Code. R. 35.01.01.271.*
  3. A 1991 ruling suggests that Vermont also provides for an allocation period from the grant date to the vesting date. *See Vt. Dept. of Taxes, Ruling 91-02 (Mar. 25, 1991).*
  4. Wisconsin provides that the allocation period is the employment contract period granting the option. *See Wis. Dept. of Rev. Pub. 122 (Nov. 2007).* In many cases, there will not be an employment contract granting the option. Presumably, the vesting period would be used in such cases.
- c. Other states provide for a different allocation period.
- (i) Ohio provides that nonresidents who exercise stock options received on account of employment in Ohio must pay Ohio individual income tax on the Ohio-related appreciation. *See Ohio Dept. of Taxation, Information Release IT 1996-01 (issued Mar. 11, 1996; revised May 2007).*
    1. For purposes of determining the Ohio-related appreciation, the non-resident must treat as Ohio income the value of the unexercised stock option at the time the individual left Ohio minus the value of the unexercised stock option at the time the individual received the option.
    2. In those cases where an individual receives a stock option prior to either moving to or working in Ohio, the Ohio-related appreciation is based upon the value of the unexercised stock option when the individual leaves Ohio minus the value of the unexercised stock option at the time the individual first became a resident of Ohio or first began working in Ohio.
  - (ii) In a general information letter, the Illinois Department of Revenue treated stock option income from an NSO as compensation for past services and applied the general rule that such income is presumed to be earned ratably over the last five years of service with the employer in the absence of clear and convincing evidence that the compensation is attributable to a different period of employment. *See Ill. Dept. of Rev., IT 05-0023-GIL (May 16, 2005).*
- d. In addition to providing for different allocation periods, some states do not allocate stock option income based on the days worked during the allocation period.

- (i) Connecticut provides for an allocation based on compensation received, where the allocation ratio equals the compensation received by the optionee from the employer for services performed in Connecticut during the allocation period divided by the total compensation received by the optionee from the employer during the allocation period. *See Conn. Agencies Regs. § 12-711(b)-(16),(18).*
    - 1. While the allocation period for Connecticut is generally from the grant date to the exercise date, for convenience purposes, the allocation period begins on the first day of the taxable year in which the option is granted and ends on the last day of the taxable year during which the option is exercised. *See Conn. Agencies Regs. § 12-711(b)-(16),(18).*
  - (ii) Virginia provides for an allocation based on the number of days as a resident of Virginia, where the allocation ratio equals the number of days during the allocation period that the optionee resided in Virginia divided by the number of days during the allocation period. *See Va. Dept. of Taxation, P.D. 05-32 (Mar. 15, 2005).*
    - 1. This ruling appears to presume that the optionee was a resident of Virginia at the time the option was granted. Query whether the same allocation formula would apply to a nonresident of Virginia who worked in Virginia at the time the option was granted?
    - 2. This ruling also provides that compensation earned from the appreciation of stock acquired through ISOs will not be considered Virginia source income for nonresidents provided that the individuals were not residents of Virginia for at least two years prior to the sale of the stock.
  - (iii) Oregon appears to require an allocation to Oregon only if the optionee worked in Oregon during the tax year the option was granted. *See Or. Admin. R. 150-316.127-(A)(3)(d)(B).* North Carolina appears to have a similar rule. *See N.C. Secretary of Rev. Decision No. 2004-200 (Dec. 14, 2004).*
- e. The differences in allocation methods among the states may result in the same compensation income being taxed in more than one state of which the optionee is a nonresident.

Example 4: Same facts as Example 3, except that Matt moved to Arizona on May 28, 2005 and continued to perform services in Arizona for the company that granted him the option until May 28, 2006.

Same result as in Example 3, except that only that portion of the \$900 of compensation income reasonably attributable to services performed in California is taxable by California.

In addition to allocating a portion of the \$900 of compensation income to California, the entire \$900 will be taxable in Arizona, Matt's state of residence at the time of the sale.

\$450 of the compensation income would be taxed by California because one-half of the income would be allocated to California based on California's allocation method described above.

Example 5: Same facts as Example 4, except that the stock option was an NSO.

Same result as in Example 4, except that the \$900 of compensation income is recognized by Matt upon the exercise of the NSO. Therefore, \$900 of compensation income is taxed by Arizona upon exercise, and \$450 of compensation income is taxed by California upon exercise because one-half of the income would be allocated to California based on California's allocation method described above.

Example 6: Same facts as Example 5, except that the NSO vested on May 28, 2005, on which date Matt terminated his employment with the company and moved to Arizona where he began work for a new employer.

Same result as in Example 5, except that all of the \$900 of compensation income recognized upon exercise is taxable in California because all of the services that generated the income were performed in California (*i.e.*, Matt only performed services in California from the grant date through the date his employment terminated).

If California did not shorten the allocation period when Matt's employment was terminated before the exercise date, then only one-half of the income (\$450) may be allocable to California despite the fact that all of the services for the employer that granted the option were performed in California.

Example 7: Same facts as Example 4, except that the ISO vested on May 28, 2005 (the day Matt moved to Arizona).

Same result as Example 4. \$450 of the compensation income recognized upon the sale of the stock would be taxed by California because the allocation period is the period from the grant date to the exercise date, not the vesting date. The allocation period in California is not based upon vesting.

If a different state were involved or a different method of allocation were used, the results could differ substantially.

For example, if Matt worked in New York (rather than California) from the grant date to the vesting date, the full \$900 of compensation income recognized upon the sale of the stock would be taxed in New York because all of the income would be attributable to services performed in New York where the allocation period is based upon vesting.

Example 8: Same facts as Example 3, but Matt sold the stock acquired upon exercise of the ISO for \$45 per share.

Matt recognizes \$800 of compensation income upon the sale of the stock, all of which is taxed by Arizona, Matt's state of residence at the time of the sale. The \$800 of compensation income would also be taxable by California.

If Matt worked in Ohio (rather than California) prior to moving to Arizona, it is unclear under the Ohio information release whether Matt would be taxable on \$900 of compensation income (the spread on the option at the time Matt left Ohio) or \$800 of compensation income (the total amount of compensation income recognized for federal tax purposes). Also, it is unclear whether Ohio is referring to the spread on the option when it refers to the value of the unexercised stock option or, for example, the Black-Scholes value of the option.

We understand from a conversation with a representative of the Ohio Department of Taxation that the income recognized for Ohio purposes (i) would be limited to the total amount of compensation recognized for federal purposes and (ii) would not be determined based on the spread but rather the differential between the Black-Scholes value of the option at grant and the time the optionee left Ohio.

Example 9: Same facts as Example 3, but Matt sold the stock acquired upon exercise of the ISO for \$5 per share.

Matt would recognize a capital loss for Arizona tax purposes. No loss would be allowable for California tax purposes. No compensation income would be recognized in Arizona or California.

## **E. Use of Tax Credits to Mitigate Double Taxation**

1. In situations where income is subject to taxation in more than one state, a tax credit may be given by one of the states to relieve the double taxation.
  - a. States generally limit the amount of the credit to the amount of tax otherwise due on the income. Accordingly, the effect of the credit generally is to tax the income at the higher rate of the two states.
  - b. In general, states impose limitations on the availability of tax credits. For example, most states provide that:
    - (i) The credit is only available if the tax is payable in both states for the same year;
    - (ii) The credit is only available if both states tax the income in the same manner; and
    - (iii) A credit is not allowed for city, county, or foreign taxes.
  - c. Typically, a state will provide its residents with a tax credit for any taxes due to another state with respect to an item of income taxed in both states.
  - d. Some states have a special method for the relief of double taxation called a “reverse credit.”
    - (i) A reverse credit allows taxpayers to take a credit for taxes due to his or her resident state against the taxes due in the nonresident state (*i.e.*, where the taxpayer earned the income) with respect to income earned in the nonresident state.
    - (ii) Reverse credits are only applicable in situations where both the taxpayer’s resident state and nonresident state allow the use of reverse credits. If only one state allows a reverse credit, the normal method for the relief of double taxation is followed and a credit is given in the taxpayer’s state of residence.
    - (iii) The following chart provides a list of states that allow for the use of a reverse credit.

<i>State</i>	<i>Nonresident Reverse Credit Allowed for Residents of</i>
Arizona	California, Indiana, Oregon, Virginia
California	Arizona, Indiana, Oregon, Virginia
Indiana	Arizona, California, District of Columbia, Oregon
Oregon	Arizona, California, Indiana, Virginia
Virginia	Arizona, California, District of Columbia, Oregon

- Some states have reciprocal agreements with other states (generally, neighboring states) to prevent double taxation in circumstances similar to those in Example 2. For example, Pennsylvania and Maryland have a reciprocal agreement, under which employees in Maryland who reside in Pennsylvania are only taxed by Pennsylvania on their income earned in Maryland as a result of the employment. The following chart provides a list of states that have reciprocal agreements. Note that the District of Columbia does not tax nonresidents.



<i>State</i>	<i>States With Reciprocal Agreement</i>
District of Columbia	Maryland, Virginia
Illinois	Iowa, Kentucky, Michigan, Wisconsin
Indiana	Kentucky, Michigan, Ohio, Pennsylvania, Wisconsin
Iowa	Illinois
Kentucky	Illinois, Indiana, Michigan, Ohio, Virginia, West Virginia, Wisconsin
Maryland	District of Columbia, Pennsylvania, Virginia, West Virginia
Michigan	Illinois, Indiana, Kentucky, Minnesota, Ohio, Wisconsin
Minnesota	Michigan, North Dakota, Wisconsin
Montana	North Dakota
New Jersey	Pennsylvania
North Dakota	Minnesota, Montana
Ohio	Indiana, Kentucky, Michigan, Pennsylvania, West Virginia
Pennsylvania	Indiana, Maryland, New Jersey, Ohio, Virginia, West Virginia
Virginia	District of Columbia, Kentucky, Maryland, Pennsylvania, West Virginia
West Virginia	Kentucky, Maryland, Ohio, Pennsylvania, Virginia
Wisconsin	Illinois, Indiana, Kentucky, Michigan, Minnesota

Example 10: Same facts as Example 2 (page 5).

Tom should be entitled to a credit in Massachusetts for the amount of taxes paid to Rhode Island with respect to the \$90 of compensation income recognized upon exercise of the NSO (to the extent the taxes do not exceed the amount of taxes due with respect to the income in Massachusetts).

Example 11: Same facts as Example 3 (page 6).

Because Arizona and California both utilize reverse credits, Matt may be entitled to a reverse credit in California for the amount of taxes due to Arizona with respect to the \$900 of compensation income recognized upon the sale of the stock (to the extent the taxes do not exceed the amount of taxes due with respect to the income in California).

Similarly, Matt may be entitled to a credit in Examples 4-8.

Example 12: Ben, a resident of Pennsylvania, was granted an ISO on July 4, 2005 to purchase 10 shares of stock with an exercise price of \$3 per share. On July 4, 2006, the stock had a fair market value of \$10 per share, and Ben exercised the ISO. In February of 2007, Ben moved to New York and sold the stock for \$20 per share.

In 2006, Ben recognizes \$70 of compensation income upon exercise of the ISO for Pennsylvania tax purposes because Pennsylvania treats all options as NSOs. Ben recognizes no income for federal tax purposes in 2006 (other than for AMT purposes).

For federal and New York tax purposes, in 2007, Ben recognizes \$70 of compensation income upon the sale of the stock and \$100 of short-term capital gain.

Ben likely will not be entitled to a credit in New York for the Pennsylvania taxes paid upon exercise of the ISO because New York follows the federal tax treatment of ISOs, and Pennsylvania taxed the compensation income in 2006, while New York taxed it in 2007.

## F. State Taxation of Qualifying Dispositions of ISOs

1. A qualifying disposition of stock acquired upon the exercise of an ISO results in the recognition of long-term capital gain, and the gain is generally only taxable in the optionee's state of residence.

Example 13: Same facts as Example 3 (page 6), except that Matt sold the stock acquired upon exercise of the ISO on August 1, 2007 for \$100 per share.

Matt recognizes \$1,900 of long-term capital gain upon the sale of the stock, all of which is taxed by Arizona, Matt's state of residence at the time of the sale, but none of which is taxed by California because the income is not from sources within California. *See AZ ITR 02-5; CA FTB Pub. 1004.*

2. Some states, however, tax nonresidents on the compensation element of income recognized upon a qualifying disposition to the extent it is attributable to services performed in the state. This could result in double taxation.
  - a. In the case of a qualifying disposition, New York has ruled that the spread on the exercise date (or, if less, the optionee's profit) is compensation and allocable to New York to the extent attributable to services performed in New York. *See TSB-M-07(7)(I); N.Y. Personal Income Tax Regs. § 132.24.*
  - b. Connecticut, Idaho, Maine and Wisconsin have adopted rules similar to those of New York. *See Conn. Agencies Regs. § 12-711(b)-(16); Idaho Admin. Code R. 35.01.01.271; 18-125 Me. Code R. § 806; Wis. Dept. of Rev. Pub. 122 (Nov. 2007).*
  - c. Despite its characterization as compensation for purposes of sourcing the income, some of these states have provided that the income will be long-term capital gain (*i.e.*, the same as the federal tax treatment). *See Idaho Admin. Code R. 35.01.01.271; Wis. Dept. of Rev. Pub. 122 (Nov. 2007). See TSB-M-95(3)(I), which has been superseded by TSB-M-07(7)(I), and TSB-M-07(7)(I) does not specifically address this point. See also in Matter of Michaelson v. New York State Tax Commission, 67 N.Y. 2d 579 (N.Y. 1986).*

**Example 14:** Same facts as Example 13, except that Matt was a resident of Idaho prior to moving to Arizona, and from the grant date to the exercise date, Matt only performed services in Idaho for the company that granted him the ISO.

Same result as in Example 13, except that Matt also must report the spread on the exercise date, \$900, as long-term capital gain in Idaho in the year of the sale.

If Matt recognizes a loss, the loss is not allowable in computing Idaho source income. Matt would be entitled to a capital loss, however, for Arizona state tax purposes.

Matt may not be entitled to a credit in Arizona for the taxes paid to Idaho because Arizona does not impose tax in the same manner as Idaho in these circumstances (*i.e.*, if Matt were a resident of Idaho and not Arizona, and he performed all services attributable to the ISO in Arizona, Arizona would not tax Matt upon the sale of the stock in a qualifying disposition).

## G. State AMT

1. Some states have an AMT, which also could result in double taxation of income. For example, California has an AMT. For purposes of the California AMT, like the federal AMT, an optionee recognizes income upon the exercise of an ISO equal to the spread on the exercise date (in the case of a nonresident, only to the extent attributable to services performed in California) unless the optionee disposes of the stock acquired upon exercise in the year of exercise.
2. In Canty v. Idaho State Tax Commission, 59 P.3d 983 (2002), the Idaho Supreme Court held that two Idaho taxpayers who paid California AMT on the exercise of ISOs in 1994 while they were residents of California were not allowed to credit the California AMT taxes paid against their Idaho income tax in 1995 and 1996, the years the stock acquired upon exercise of the ISOs was sold, because the credit was only available in Idaho in the year the taxes were payable in California. *See also Va. Dept. of Taxation, P.D. 05-163 (Dec. 5, 2005).*

Example 15: Same facts as Example 3 (page 6).

Matt must include as a California AMT adjustment the spread on the exercise date (\$900) because all of the services that generated the option spread were performed in California.

Depending on Matt's particular circumstances, this could cause Matt to pay California AMT in the year of exercise.

If Matt is required to pay California AMT, Matt may be allowed to credit some of the AMT paid against regular California taxes in subsequent years, such as on any tax attributable to a disqualifying disposition; however, if he has a qualifying disposition and does not have any other income in California, Matt may never receive a credit.

In addition, Matt may not be entitled to a reverse credit in California for any Arizona taxes paid on the option spread because any California AMT would not be due for the same year that the taxes on the spread would be due in Arizona (Arizona does not have an AMT), and little or no California taxes are likely to be due on the option spread in the year Arizona taxes are due on the spread because of the AMT credit.

## **H. State Taxation of ESPP Stock**

1. Most states follow the federal tax treatment of employee stock purchase plan ("ESPP") stock.
  - a. Pennsylvania does not follow the federal tax treatment of ESPP stock. When the employee receives the stock, the employee will have income equal to the difference between the fair market value of the stock at such time and the amount the employee paid for the stock. *See Pa. Dept. of Rev., PIT-00-068 (April 28, 2000); Pa. Dept. of Rev., PIT-00-003 (Jan. 14, 2000).*
2. For federal income tax purposes, employees will not have income when they enroll in an ESPP or when they purchase stock at the end of an offering.

3. Employees may recognize both compensation income and capital gain income if they sell stock acquired under an ESPP at a profit (*i.e.*, the sales proceeds exceed the employee's purchase price).
  - a. If an employee sells the stock in a qualifying disposition (*i.e.*, more than two years after the grant date of the underlying ESPP option and more than one year after the date that the employee purchased the stock), the employee generally will have compensation income equal to the lesser of any discount on the price of the stock on the day the offering commenced and the employee's profit. Any excess profit will be long-term capital gain.
  - b. If the employee sells the stock in a qualifying disposition at a loss (*i.e.*, the sales proceeds are less than the purchase price), then the loss will be a capital loss.
4. If the employee sells the stock prior to satisfying the requisite waiting periods, the employee will have engaged in a disqualifying disposition, and will have compensation income equal to the value of the stock on the day the employee purchased the stock less the purchase price. If the employee's profit exceeds the compensation income, then the excess profit will be capital gain. If the employee's profit is less than the compensation income, then the employee will have a capital loss equal to the value of the stock on the day the employee purchased the stock less the sales proceeds.
5. Generally, for state tax purposes, all ordinary and capital gain income or loss recognized upon a qualifying or disqualifying disposition will be taxable or allowable in the employee's state of residence. (The treatment is generally the same as for stock options.)
6. Generally, when the employee performs services in a state other than his or her state of residence, the compensation element recognized in a qualifying or disqualifying disposition will be allocated to that state, based upon that state's allocation formula. The capital gain portion will not be taxable, and no capital loss will be allowable, in the nonresident state. (The treatment is generally the same as for stock options.) *See, e.g., AZ ITR 02-5; CA FTB Pub. 1004.*

## **II. State Taxation of Employer**

### **A. State Income Tax Withholding**

1. Most states follow the federal income tax withholding rules with respect to compensation income recognized upon the exercise of a stock option or the sale of stock acquired upon exercise.

2. For federal income tax purposes, employers are required to withhold federal income tax from compensation income recognized upon the exercise of an NSO by an employee (current or former). The income qualifies as supplemental compensation, and employers generally may withhold tax at a flat rate of 25% (for tax years 2003-2010) from the income. If an optionee receives more than \$1 million in supplemental compensation during a year, tax must be withheld at a flat rate of 35% from all supplemental compensation in excess of \$1,000,000. Some states also have a flat rate for withholding from supplemental compensation.
3. For federal income tax purposes, employers currently are not required to withhold federal income tax from compensation income recognized upon the disqualifying disposition of stock acquired upon the exercise of an ISO, although employers must report the income on Form W-2.
4. Generally, employers subject to the withholding rules in a state are required to withhold state income tax from compensation income paid to an employee if the income is taxable by the state and federal income taxes must be withheld from the income.
  - a. An employer generally is subject to the withholding rules in a state if the employer maintains an office or transacts business within the state. An employer also may be subject to the withholding rules in a state if the employer derives income from sources within the state.
  - b. A state's definitions of "employee" and "employer", however, may vary from the federal definitions of those terms, and "Section 530 Relief" may not be available at the state level.
5. Some states require withholding with respect to an ISO.
  - a. Because Pennsylvania taxes ISOs in the same manner as NSOs, employers subject to the withholding rules in Pennsylvania are required to withhold Pennsylvania income taxes from compensation income recognized upon the exercise of an ISO for Pennsylvania tax purposes. *See Pa. Dept. of Rev., PIT-03-037 (Dec. 30, 2003).*
  - b. In a 1997 Tax Release, Wisconsin required withholding from compensation income attributable to an ISO. The release also required withholding on a qualifying disposition by a nonresident to the extent of any long-term capital gain sourced to Wisconsin (See Section I., F., 2. and Example 14 above). *See Wis. Dept. of Rev. Tax Bulletin No. 103 (Oct. 1, 1997).* We question whether this release reflects Wisconsin's current position in light of the change to federal law regarding withholding with respect to ISOs after its issuance. Wisconsin's most recent publication related to stock options does not address withholding. *See Wis. Dept. of Rev. Pub. 122 (Nov. 2007).*

Example 16: Same facts as Example 1 (page 4). Assume Tom is an employee of the company that granted him the NSO.

The company must withhold Massachusetts income taxes from the \$90 of compensation income recognized upon exercise of the NSO, even though Tom receives no cash payment.

Generally, Tom will be required, upon exercise, to pay to the company the amount of the withholding taxes.

Example 17: Same facts as Example 3 (page 6). Assume Matt is an employee of the company that granted him the ISO.

The company is not required to withhold California or Arizona income taxes from the compensation income recognized by Matt upon the sale of the stock acquired upon exercise of the ISO because no federal income tax withholding is required on the income.

## **B. Multi-State Withholding Issues**

1. Employers subject to the withholding rules in a state generally are required to withhold state income taxes from the compensation income recognized by an employee, who is a resident of the state, upon the exercise of an NSO because all of the income is taxable by the state. If the resident performed the services that generated the income in another state, depending on the state of residence, the employer may be allowed to reduce the amount of taxes required to be withheld from the income in the state of residence by the amount of taxes withheld from the income in the state that the services were performed. Some states do not require the employer to withhold any state income taxes from a resident's compensation income if the resident performs the services that generated the income solely in another state.
2. Employers subject to the withholding rules in a state generally are required to withhold state income taxes from the compensation income recognized by an



employee, who is not a resident of the state, upon the exercise of an NSO to the extent the income is attributable to services performed in the state.

3. If an optionee resides in one state and performs services in another state, the employer may be required to withhold taxes of both states from the compensation income recognized upon exercise of an NSO.

Example 18: Same facts as Example 2 (page 5). Assume Tom is an employee of the company that granted him the NSO.

The company must withhold Rhode Island income taxes from the \$90 of compensation income recognized by Tom upon exercise of the NSO because Tom performed all of the services that generated the compensation income in Rhode Island.

If the company is subject to the withholding rules in Massachusetts, the company also must withhold Massachusetts income taxes from the \$90 of compensation income because Tom is a resident of Massachusetts, but the company must reduce the amount of Massachusetts income taxes required to be withheld by the amount of Rhode Island income taxes withheld. As a result, taxes effectively are withheld at the higher rate of the two states.

4. Some states may not allow an employer to reduce the state income taxes withheld from a resident's compensation income by the amount of income taxes withheld from the income by the employer in another state. In such case, the employee may be entitled to a tax credit in his or her state of residence as described in Section I., E. If the employee is entitled to a credit, he or she will receive a refund for some or all of the income taxes withheld in the state of residence (although the refund will not be received until after his or her tax return for the year is filed).
5. The reciprocal agreements that states enter into to avoid double taxation have provisions designed to avoid duplicative withholding (*e.g.*, pursuant to a reciprocal agreement between Wisconsin and Illinois, a Wisconsin employer that employs a resident of Illinois in Wisconsin is not required to withhold Wisconsin income taxes from compensation paid to the employee, provided

that the employee furnishes verification of residency to the employer). See the chart at Section I., E., 2. for a list of states that have reciprocal agreements.

6. Special rules for withholding may be found in the states that utilize reverse credits. These rules may exempt a portion or all of the income earned by a nonresident from withholding when the employee's state of residence uses reverse credits.
7. Some states require employers subject to the withholding rules of the state to withhold from all of a nonresident's compensation income if a portion is attributable to services performed in the state unless the nonresident provides adequate information to the employer, or the employer maintains adequate records, for purposes of determining the amount of income attributable to services performed in the state.

Example 19: Same facts as Example 18, except that Tom performed services for the company that granted him the option for 300 days in Rhode Island and 700 days in Massachusetts from the grant date to the exercise date.

Tom recognizes \$90 of compensation income upon the exercise of the NSO, all of which is taxable in Massachusetts because Tom is a resident of Massachusetts. The company must withhold Massachusetts income taxes from all \$90 of compensation income because Tom is a resident of Massachusetts, but the company must reduce the amount of Massachusetts income taxes required to be withheld by the amount of Rhode Island income taxes withheld, as discussed in Example 18.

Because Tom is a nonresident of Rhode Island, the company need only withhold Rhode Island income taxes from the compensation income attributable to services performed in Rhode Island.

An allocation method based on time worked during the period from grant to exercise should be reasonable for purposes of determining the compensation income attributable to services performed in Rhode Island. Accordingly, the company should only be required to withhold Rhode Island income tax from \$27 ( $300/1000 \times \$90$ ) of the compensation income.

### C. Inclusion of Option Income in the Payroll Factor

1. Most states impose an income tax on the net business income of a corporation apportioned to the state. Many states use a three-factor formula to determine the corporation's apportionment percentage. The three factors generally are sales, property, and payroll.

For example, if 15% of a corporation's sales during a tax year are in a state, 20% of a corporation's property is located in the state, and 25% of the total compensation paid by the corporation to its employees during the year is paid to employees in the state, then the corporation's apportionment percentage is 20% (assuming a three-factor formula with each factor weighted equally). Accordingly, 20% of the corporation's net business income is apportioned to the state.

2. Although the compensation income recognized by employees with respect to a stock option often is attributable to services performed in more than one year, the compensation income is recognized in a single year for tax purposes. Accordingly, many states are likely to require the inclusion of the compensation income in their payroll factor in the year the compensation income is recognized.
  - a. The California Franchise Tax Board has indicated that compensation income from stock options will be included in the payroll factor in the year it is recognized. *See Ca. Franchise Tax Board Internal Procedures Manual § 7322 (Dec. 2002).*
  - b. Inclusion in the payroll factor of compensation income attributable to a stock option could cause a disproportionate amount of a corporation's net business income to be apportioned to or away from a state in the year of exercise or sale. Note that most states provide for alternative apportionment methods when necessary to reflect income properly.
3. Generally, an employee's compensation income for a year is only included in the numerator of the payroll factor of one state unless the employee transfers or changes positions.
  - a. If an employee performs services within and without a state during a tax year, the employee's compensation generally is assigned to the state if the employee's base of operations is in the state. If no base of operations exists, the compensation generally is assigned to the state if the employee's service is directed or controlled from the state. If the base of operations or the place from which the service is directed or controlled is not in any state in which the employee performs services, the compensation generally is assigned to the state if it is the residence of the employee.

Example 20: Same facts as Example 19, except that Tom performed services for the company that granted him the option for 300 days in Connecticut and 700 days in Massachusetts from the grant date to the exercise date.

The \$90 of compensation income recognized by Tom upon the exercise of the NSO should be included in the numerator of the company's payroll factor in Massachusetts (assuming that Tom's base of operations is in Massachusetts) but should not be included in the numerator of the company's payroll factor in Connecticut although a portion of such income would be taxable in Connecticut.

If the facts were the same as in Example 19 (*i.e.*, Tom performed 300 days of service for the company in Rhode Island), the \$27 of compensation income attributable to services performed in Rhode Island may be included in the numerator of the company's payroll factor in Rhode Island because Rhode Island does not follow the general rule described above.

#### **D. Employer Deductions**

1. An employer is generally entitled to a compensation deduction for state income tax purposes at the same time and in the same amount as for federal income tax purposes.
2. In certain circumstances, an employer may be entitled to a compensation deduction for state income tax purposes although the employer is not entitled to a deduction for federal income tax purposes.
  - a. Because Pennsylvania taxes ISOs in the same manner as NSOs, employers are entitled to deduct the compensation income recognized by optionees upon the exercise of ISOs for Pennsylvania tax purposes.
  - b. Employers arguably may be able to deduct the compensation element recognized by optionees upon the qualifying disposition of stock acquired upon the exercise of ISOs in states that characterize the income as compensation for sourcing purposes (as discussed above in Example 14).