STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
E. RANDALL STUCKLESS AND JENNIFER OLSON	:	DECISION DTA NO. 819319
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1997 and 1998.	:	

Petitioners E. Randall Stuckless and Jennifer Olson, 68 Partridge Hill, Honeoye Falls, New York 14472, filed an exception to the determination of the Administrative Law Judge issued on July 8, 2004. Petitioners appeared by Arnold R. Petralia, Esq. The Division of Taxation appeared by Mark F. Volk, Esq. (Barbara J. Russo, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition and petitioners filed a reply brief. Oral argument, at petitioner's request, was heard on November 17, 2004 in Troy, New York. The Tax Appeals Tribunal issued a decision dated May 12, 2005.

The Division of Taxation filed a motion for reargument dated September 9, 2005 accompanied by a memorandum of law in support. Petitioner filed an affirmation and memorandum of law in opposition dated September 20, 2005. A motion for reargument of a decision of the Tax Appeals Tribunal is provided for in section 3000.16(c) of the Tax Appeals Tribunal's procedural rules. Unlike subsections (a) and (b) of section 3000.16 which govern motions for reargument of a determination of an Administrative Law Judge before the filing of

an exception with the Tax Appeals Tribunal, subsection (c) does not limit the grounds on which the Tax Appeals Tribunal may grant a motion for reargument of a decision of the Tax Appeals Tribunal. The Tax Appeals Tribunal accordingly looked to the standards applied by the courts in similar circumstances and, finding that those standards had been met, granted the motion in an order and opinion dated December 15, 2005 (***see***, CPLR 2221[d][2]; ***Foley v. Roche***, 68 AD2d 558, 418 NYS2d 588, ***lv denied***, 56 NY2d 507, 453 NYS2d 1025; ***Matter of Schulkin***, Tax Appeals Tribunal, November 20, 1997).

On reargument, the Division of Taxation and petitioner both filed briefs dated January 30, 2006. Oral argument was held on March 22, 2006 in Troy, New York. Amicus curiae briefs were filed by Hodgson Russ LLP (Paul R. Comeau, Esq. and Jack Trachtenberg, Esq., of counsel) and the New York State Society of Certified Public Accountants (James A. Woehlke, Esq. and Dennis M. O'Leary, Esq., of counsel).

After reviewing the entire record in this matter, the Tax Appeals Tribunal withdraws its decision dated May 12, 2005 and renders the following decision.

ISSUES

I. Whether income received by petitioners from the exercise of stock options while petitioner E. Randall Stuckless was a nonresident of New York is subject to personal income tax as New York source income.

II. Whether the Division of Taxation properly allocated the stock option income based on days worked in and out of the State.

III. Whether reasonable cause exists for the abatement of the penalties imposed for failure to file a return and for negligence.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

On October 21, 2002, following an audit, the Division of Taxation ("Division") issued to petitioners, E. Randall Stuckless and Jennifer Olson,[1] a Notice of Deficiency which asserted additional tax due for the year 1997 of $13,735.73 and for the year 1998 of $35,084.23, for a total amount due of $48,819.96. The Notice of Deficiency also asserted penalty and interest due for each of the years at issue.

The Division's audit of petitioner for the years 1997 and 1998 focused on the difference between petitioner's Federal adjusted gross income (AGI) and New York source income as reported. Specifically, the Division increased the amount of petitioner's income from Microsoft Corporation ("Microsoft") allocable to New York for each of the years at issue. The method used by the auditor to apportion the gain realized on the exercise of incentive stock options ("ISO") to New York was based on the number of New York working days from the option grant date to the exercise date compared to the total number of days worked both in and out of New York for the same period. The Division made no adjustments to petitioner's reported Federal AGI.

The options exercised in 1997 were granted in 1991, when petitioner was a resident of New York. The Division allocated the proceeds from the stock options from the date of grant, November 4, 1991, to the dates of exercise. The options that were exercised in 1998 were

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[1] Jennifer Olson is a petitioner in this matter solely because she filed a joint New York nonresident and part-year resident income tax return with her spouse, E. Randall Stuckless, for 1998. All of the income at issue was paid to E. Randall Stuckless. Accordingly, unless otherwise indicated, all references to petitioner herein shall refer to E. Randall Stuckless.

granted in 1992, also when petitioner was a resident of New York. The Division allocated the proceeds from the stock options from the date of grant, July 7, 1992, to the dates of exercise. The Division determined petitioner's residency allocation for the relevant years and periods, as follows: 1992, 1993, 1994, 1995, and January 1, 1996 through September 1, 1996, when petitioner moved out of New York State, 100% allocation; September 1, 1996 through December 31, 1996, 1997 and January 1, 1998 through July 5, 1998, 0% allocation; and July 6, 1998, when petitioner moved back to New York State, through December 31, 1998, 100% allocation.

Petitioner did not file a 1997 New York return. On his Federal return for that year petitioner reported $281,141.00 in adjusted gross income, including $292,454.00 in wage income, which corresponds to the amount of wage income reported by Microsoft to have been paid to petitioner in 1997. On audit the Division determined that $202,351.92 of this Microsoft income was allocable to New York and asserted New York tax due of $13,735.73.

On his 1998 New York return petitioner reported New York adjusted gross income of $60,781.00 and Federal adjusted gross income of $709,866.00. During the tax year 1998, Microsoft paid petitioner $739,155.00 in wage income. On audit, the Division determined that $526,799.00 of this Microsoft income was allocable to New York and asserted New York tax due of $39,153.23.

E. Randall Stuckless worked for Microsoft during the period in issue and is currently employed by Microsoft.

Microsoft granted Mr. Stuckless incentive stock options to buy Microsoft stock on November 4, 1991 and July 7, 1992. The Stock Option Plan which granted the ISO's provided as its purpose as follows:

> The purposes of this Stock Option Plan are to attract and retain the best available personnel for positions of substantial responsibility, to provide additional incentive to such individuals, and to promote the success of the Company's business by aligning employee financial interests with long-term shareholder value.

The plan further provided that options were only to be granted to employees, and directors were not eligible to participate in the plan unless they were full-time employees. The per share exercise price was based upon the number of shares owned by the employee at the time of the grant of the ISO. Where the employee owned shares representing more than 10% of the voting power of all classes of shares of Microsoft, the per share exercise price was not to be less than 110% of the fair market value per share on the date of the grant. For any other employee, the per share exercise price was not to be less than 100% of the fair market value per share on the date of the grant.

In the event of termination of an option holder's continuous status as an employee, the option holder was required to exercise the stock options within three months of termination. However, the plan provided for the increase of the period for exercising the stock option following termination where termination of employment occurred as a result of death (6 months), total and permanent disability (12 months) or under any other circumstances where the Board of Directors deemed an extension to be appropriate, as long as the extension did not exceed the term of the option as originally issued.

In addition, the plan provided that the option may not be sold, pledged, assigned, hypothecated, transferred or disposed of in any manner other than by will or by the laws of descent or distribution and may be exercised, during the lifetime of the option holder only by the option holder provided that the Board may permit further transferability, on a general or specific

basis, and may impose conditions and limitations on any permitted transferability. The plan further provided that an option holder's right to exercise his or her stock option generally vests in increments over time.

Mr. Stuckless was a New York State resident and worked in New York when the options were granted.

Jennifer Olson was a resident of New York State in 1991 and 1992.

The options were granted under a document entitled "Microsoft Corporation 1991 Stock Option Plan."

Mr. Stuckless moved to Seattle, Washington on September 1, 1996.

Mr. Stuckless resided in Seattle, Washington until he moved back to New York on or about July 4, 1998.

From September 1, 1996 to July 4, 1998, petitioners were nonresidents of New York.

On or after July 5, 1998, petitioners were New York State residents.

At various times while a Washington resident, Mr. Stuckless exercised a portion of the ISO's and sold the option stock. Each ISO exercise was simultaneous with a sale of the underlying stock. Mr. Stuckless also exercised options, and sold stock, while residing in New York, but these transactions are not at issue in this proceeding.

ISO stock sold between September 1, 1996 and July 4, 1998 was sold while Mr. Stuckless was a resident of the State of Washington. Stock sales after July 4, 1998 occurred after he had moved back to New York and was a New York resident.

Petitioners concede that income from the ISO exercise and sales occurring after July 4, 1998 is taxable to New York State.

The ISO's that were exercised while Mr. Stuckless resided in the State of Washington, the quantity, grant date, grant number, grant price, market price as well as the gain per New York and allocation to New York as determined on audit are as follows:

Exercise and Sales Date	Quantity	Grant Date	Grant #	Grant Price	Market Price	Gain per New York	Alloc. to NY per Audit
1/27/97	1600	11/4/91	014321	1.896	12.0000	16,166.64	15,961.08
4/17/97	3200	11/4/91	014321	1.896	12.3906	32,583.36	32,076.73
4/29/97	2400	11/4/91	014321	1.896	14.8125	30,999.96	29,186.84
5/8/97	1600	11/4/91	014321	1.896	14.3906	19,991.68	18,728.90
6/3/97	1200	11/4/91	014321	1.896	15.2656	16,043.76	14,851.17
7/11/97	1200	11/4/91	014321	1.896	16.1563	17,112.48	15,546.09
7/17/97	1200	11/4/91	014321	1.896	18.5234	19,953.12	18,076.95
9/17/97	800	11/4/91	014321	1.896	17.3046	11,870.84	10,446.34
10/8/97	400	11/4/91	014321	1.896	17.3046	6,163.54	5,370.21
11/4/97	600	11/4/91	014321	1.896	16.7734	8,926.56	7,746.92
11/10/97	400	11/4/91	014321	1.896	16.3906	5,797.92	5,015.24
11/18/97	600	11/4/91	014321	1.896	16.8438	8,968.74	7,727.63
12/2/97	800	11/4/91	014321	1.896	18.0730	12,939.56	11,091.05
12/17/97	800	11/4/91	020478	2.125	17.4765	12,281.24	10,526.78
1/7/98	800	7/792	020478	2.125	16.0225	11,118.76	8,313.89
1/12/98	400	7/7/92	020478	2.125	16.1719	5,618.75	4,191.84
1/28/98	800	7/7/92	020478	2.125	18.5406	13,212.52	9,776.08
2/27/98	400	7/7/92	020478	2.125	21.4530	7,731.26	5,632.04
3/10/98	400	7/7/92	020478	2.125	20.1563	7,212.50	5,227.21
3/27/98	400	7/7/92	020478	2.125	22.0313	7,962.50	5,716.37

4/15/98	800	7/7/92	020478	2.125	22.6875	16,450.00	11,699.35
4/28/98	1200	7/7/92	020478	2.125	22.7030	24,693.78	17,449.57
6/26/98	1000	7/7/92	020478	2.125	25.9375	23,812.50	16,337.06

The market price at which each option stock sale was made is based upon a printout from Microsoft entitled "Exercise History for E. Randall Stuckless."

The market price of Microsoft stock when petitioners left New York on September 1, 1996, adjusted for stock splits, was $7.710938 per share. This is based on the NASDAQ Exchange close for September 3, 1996, as September 1, 1996 was a Sunday and September 2, 1996 was Labor Day. As the stock market was closed on both days, the first trading day after September 1, 1996 would have been September 3, 1996.

As the above table indicates, the option price for the 1991 ISO's was $1.896 per share except for the one exercised on 12/17/97 which was $2.125 per share, the same option price for the ISO's granted in 1992. The 1997 ISO's were exercised and stock sold at prices ranging between $12.00 and $18.00 per share. The ISO's exercised between January and July 4, 1998 were at prices ranging between $16.00 and $26.00 per share.

The total amount of appreciation for the stock options exercised in 1997 as of September 1, 1996 was $97,508.00, while the Division's method of allocation resulted in a gain on the exercise of these stock options of $202,352.00. For the stock options exercised in 1998, the amount of appreciation as of September 1, 1996 was $34,633.00, while the Division's method of allocation resulted in a gain of $84,343.00. The cause of the difference in the amounts of the gain between that computed as of September 1, 1996 and the Division's method of allocation is

that the appreciation in Microsoft stock after September 1, 1996 was greater than the appreciation of the stock between the date of grant and September 1, 1996.

Petitioners did not file a New York State income tax return for 1997, and filed a joint Nonresident and Part-Year Resident Income Tax Return for the year 1998. During each of the years at issue, petitioner received income from Microsoft which was reported by Microsoft on form W-2.

On or about October 28, 1997, petitioners separated, and were divorced on or about May 28, 1999.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge found that income from the stock options awarded to petitioner was secured or earned through petitioner's employment in New York and was properly considered New York source income for the years at issue. The Administrative Law Judge noted that in ***Matter of Michaelsen v. New York State Tax Commn.*** (67 NY2d 579, 505 NYS2d 585), the Court of Appeals held that income realized from employee stock options issued for past or future services constitutes compensation attributable to a nonresident's business, trade, profession or occupation carried on in New York where a nonresident individual was employed in New York and that the amount of such compensation is to be measured by the difference between the option price and the fair market value of the stock on the date of exercise of the option. The Administrative Law Judge also rejected as not supported by the evidence in the record petitioner's argument that his rights did not vest until he exercised the options while a resident of Washington in 1997 and 1998.

The determination then discussed Technical Services Bureau Memorandum TSB-M-95(3)I (November 21, 1995), which sets forth the position of the Division that the source of income from employee stock options is to be determined by reference to the ratio of days worked within New York to total work days for the entire period from the date of grant of the options until the date of exercise. The Administrative Law Judge found that TSB-M-95(3)I was a reasonable interpretation of ***Michaelsen*** and of the Tax Law and regulations and that it was entitled to deference as a not irrational or unreasonable interpretation or construction of a statute by an agency charged with its administration (***see***, Tax Law §§ 170, 171). He also held that the issuance of TSB-M-95(3)I did not violate the State Administrative Procedure Act because it is merely an interpretative statement without legal effect.

The determination rejected petitioner's assertion that the Division was estopped from applying the method set forth in TSB-M-95(3)I because a different method was applied in another case before an Administrative Law Judge. Tax Law § 2010(5) provides that determinations of Administrative Law Judges shall not be given any force or effect in any other proceedings and, thus, cannot be the basis of an estoppel.

The Division assessed penalties for failure to file a return pursuant to Tax Law § 685(a)(1)(A) for 1997 and for negligence pursuant to Tax Law § 685(b)(1) and (2) for 1997 and 1998. The Administrative Law Judge sustained those penalties.

ARGUMENTS ON EXCEPTION

Petitioner argues that the Administrative Law Judge erred in finding that the gain on his stock options was secured and earned through his New York employment. Petitioner asserts that a multiple year allocation method imposed by the Division under TSB-M-95(3)I violates the

annual tax accounting concept contemplated by Tax Law § 638(2) and that only services rendered in New York during the year of exercise should be considered in determining the source of income (***see***, Petitioner's brief in support, pp. 8-10; Petitioner's brief on reargument, pp. 7-11). Moreover, the governing regulation in this case is not subsection (a) of 20 NYCRR 132.18 but rather subsection (b) which specifically provides that periods in which no services are performed in New York are excluded from the allocation formula (***see***, Petitioner's brief in support, pp. 9-10; Petitioner's reply brief, pp. 3-4; Petitioner's memorandum in opposition to motion, pp. 4-5, 7-8; Petitioner's brief on reargument, pp. 11-12). Since petitioner's New York employment terminated when he moved to Washington in 1996, the result under that regulation is said to be no allocation of income to New York.

Petitioner also asserts that TSB-M-95(3)I violated the State Administrative Procedure Act and Tax Law § 171(23rd) which states, "In no event shall technical memoranda be issued by the department in violation of the provisions of the state administrative procedure act where and to the extent that a duly promulgated rule or regulation would be required" (Petitioner's brief in support, pp. 21-23). In addition, petitioner maintained that the Administrative Law Judge should have granted collateral estoppel because of a prior unrelated tax determination by an Administrative Law Judge (***see***, Petitioner's brief in support, pp. 19-21).

As an alternative contention, petitioner stated that the Division should have provided or permitted the use of a more equitable alternative method of allocation pursuant to 20 NYCRR 132.24 by using stock market data to make an allocation between appreciation that occurred while petitioner lived and worked in New York and appreciation that occurred while petitioner

lived and worked in Washington (***see***, Petitioner's brief in support, pp. 5, 17-19). Petitioner also claimed that penalties should have been abated (***see***, Petitioner's brief in support, p. 23).

The Division contended that the determination of the Administrative Law Judge was correct and should be sustained. It asserts that "the date of grant of the stock options was a crucial factor in the Michaelsen decision" because under the applicable provision of the Internal Revenue Code the strike price of the option must equal the fair market value of the stock when the option is granted (Division's brief in opposition, p. 5). The Division also argues that TSB-M-95(3)I "reflects the court's holding in Michaelsen regarding the valuation of stock options, and is a reasonable interpretation of the Income Tax Regulations for nonresident income" (Division's brief in opposition, p. 12). As an interpretation or construction of a statute by an agency charged with its administration, it is said to be entitled to deference (***see***, Division's brief in opposition, pp.12-13; Division's brief on reargument, pp. 7-8).

The Division also argued that the method of allocation provided in TSB-M-95(3)I is authorized by 20 NYCRR 132.4(c) and 132.18 and is an alternative method authorized by 20 NYCRR 132.24 (***see***, Division's brief on reargument, pp. 3-6).

OPINION

The New York personal income tax is imposed on a nonresident individual's taxable income which is derived from sources within New York State (***see***, Tax Law § 601[e]). A nonresident individual's New York source income includes the net amount of items of income, gain, loss and deduction entering into the individual's Federal adjusted gross income derived from or connected with New York sources, including income attributable to a business, trade, profession or occupation carried on in New York (***see***, Tax Law §§ 631[a], 631[b][1][B]).

Income from intangible property constitutes income from New York sources only to the extent that it is from property employed in a business, trade, profession or occupation carried on in New York (***see***, NY Const, art XVI, § 3; Tax Law § 631[b][2]).

The determination of income subject to New York personal income tax begins with adjusted gross income for Federal income tax purposes (***see***, Tax Law §§ 612[a], 631[a][1]). The Federal income tax treatment of employee stock options is well understood and is not in dispute. Employee stock options fall into two general categories–*viz*., (i) statutory stock options which enjoy special tax benefits to the employee as provided in specific provisions of the Internal Revenue Code and (ii) nonstatutory stock options which are subject to tax under general principles of Federal income taxation developed by the courts and set forth in Treasury regulations. Statutory options have been subject to varying provisions and have been referred to in the Internal Revenue Code from time to time as "restricted" stock options, "qualified" stock options and "incentive" stock options. Options are generally conditioned on the employee completing a specified period of employment. At the end of that period, the options become nonforfeitable and exercisable, which is usually called "vesting." The options remain vested until they expire or are exercised. In the case of both statutory and nonstatutory options, there are normally no tax consequences to the employer or employee upon the grant or vesting of the options. On the exercise of a nonstatutory option, the employee will realize and recognize ordinary income treated as compensation for services rendered equal to the difference between the fair market value of the stock received and the option price paid. By contrast, on the exercise of a statutory option the employee will have no recognition of income. If certain holding period requirements set out in the Internal Revenue Code are met, the employee will enjoy long-term

capital gain treatment on gain recognized on the ultimate sale of the stock or a tax-free step-up in basis at death (***see***, Internal Revenue Code §§ 421-424, 1014; Treas. Reg. §§ 1.83-7, 1.421-1, -2).

The Court of Appeals in 1986 held that the stock option income of a nonresident who worked in New York was not investment income, which would be exempt from tax, but rather was compensation attributable to a business, trade, profession or occupation carried on in New York and therefore properly subject to New York personal income tax (***Matter of Michaelsen v. New York State Tax Commn.***, ***supra***). Since ***Michaelsen*** is the foundation case on this subject and there is some disagreement between the parties about what it held, it seems worthwhile to describe the case in detail as well as its bearing on the issues presented here.

The taxpayer in ***Michaelsen*** was a resident of Connecticut who worked in New York City as an executive for Avon Products, Inc. He was granted options on Avon stock in 1968. In 1972, he exercised some of his options purchasing 3,000 shares; in 1973, he exercised additional options purchasing another 3,000 shares and later in 1973 he sold all 6,000 shares. He did not report any part of the resulting income on his New York nonresident income tax return. The State Tax Commission treated the taxpayer's stock options as a form of compensation "for past services to Avon or as an incentive for future services to Avon" with the result that the income from the exercise of the options and sale of the stock constituted compensation connected with New York sources and was includible in the taxpayer's New York adjusted gross income for 1973 (***Matter of Michaelsen,*** State Tax Commn., February 4, 1983).

The Supreme Court dismissed the taxpayer's Article 78 proceeding to annul the State Tax Commission's decision, finding that the decision had a rational basis because "there was no evidence indicating that the options through which the stock was acquired were issued other than as a form of compensation . . . for either past services or incentive for future services." The Supreme Court rejected the argument that the stock option income was exempt from tax as income from intangible personal property under Tax Law § 631(b)(2) because that section was "not meant to cover taxpayers who receive stock options in lieu of compensation" (***Matter of Michaelsen v. New York State Tax Commn.***, 122 Misc 2d 824, 471 NYS2d 789, at 790).

The Appellate Division found that the State Tax Commission and Supreme Court had erred and concluded that "the only income attributable to New York is the value of the stock option on the date it became exercisable" (***Matter of Michaelsen v. New York State Tax Commn.***, 107 AD2d 389, 486 NYS2d 479, at 481).

The Court of Appeals rejected both the Appellate Division's holding and the analysis of the State Tax Commission and the Supreme Court, stating in part as follows:

> Gain derived from these . . . options is *realized* when the option is exercised; the option is valued by subtracting the option price from the fair market value of the stock when the option is exercised . . . . This gain is characterized by Federal authorities as compensation for services performed . . . . Although the gain on qualified stock options, such as the options granted to petitioner, is *realized* at the time the options are exercised, the gain is not *recognized* until the stock is disposed of. Thus, although under Federal law both the gain on the appreciation of the stock after it is purchased and the compensation derived from the exercise of the option are actually *recognized* when the stock is sold, there are two realization events reflecting the taxation of two distinct accretions to income.
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> Taxing only the difference between the fair market value of the stock on the date the option is first exercisable and the option price differs from Federal law and leaves much of the compensation to the employee untaxed. Plainly the

> option on the date it becomes exercisable is worth more than merely the difference between the fair market value of the stock at that time and the option price. Indeed, they are usually the same. The employee's compensation comes from employer's willingness to let the employee benefit from market appreciation in the stock without risk to his own capital. . . . [T]his extra value cannot be adequately measured on the date the option becomes exercisable . . . . [W]e conclude that the proper method of valuing the compensation derived from an option that has no readily ascertainable fair market value on the date it is granted is to subtract the option price from the fair market value of the stock on the date the option is exercised.
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> Any gain petitioner realized from an increase in the market value of Avon stock between the time the option was exercised and the time the stock was sold is clearly investment income rather than compensation and, as a nonresident, petitioner cannot be taxed on this amount (***Matter of Michaelsen v. New York State Tax Commn.***, ***supra***, 505 NYS2d, at 588-589 [footnote omitted]).

Because the record did not reveal the value of the Avon stock on the dates the options were exercised, the matter was remitted to the State Tax Commission for an appropriate assessment of tax based upon the difference between the option prices and the fair market value of the stock when the options were exercised.

The Court of Appeals was confronted with two problems in ***Michaelsen.*** The first problem was the character of the income resulting from the options. Unlike the Internal Revenue Code, the New York Tax Law provides no preferential treatment for statutory stock options or for capital gains. Income of a nonresident from intangible property, such as corporate securities, is, however, generally exempt from personal income tax. If the requirements of the Internal Revenue Code are met, income from stock acquired on the exercise of statutory stock options is treated in its entirety for Federal tax purposes as capital gain from corporate stock which is intangible property. The court rejected this characterization for New York tax purposes and, in

effect, concluded that statutory options should be treated in the same fashion as nonstatutory options in determining the nature of the income produced.

The second problem is one of timing. In the case of nonstatutory options, the income will be recognized and reported in the year of exercise. In the case of statutory options, the income will be recognized and reported only in the year that the stock is sold. The determination of income for purposes of the personal income tax begins with Federal adjusted gross income for the taxable year. Thus, if statutory options were to be treated like nonstatutory options for New York tax purposes, there would be a mismatch between the year in which the income was realized and when it would appear on the tax return of the optionee. This problem might be addressed by treating the spread on a statutory option as income recognized in the year of exercise just as in the case of a nonstatutory option. In effect, this would be a modification increasing the taxpayer's federal adjusted gross income for purposes of determining New York adjusted gross income (***see***, Tax Law §§ 612[b], 631[a][2]). Such a solution, however, would presumably require an amendment of the Tax Law. The court's holding in ***Michaelsen*** is confined to the characterization issue discussed above and does not alter the rule that recognition of income represented by the spread on exercise is deferred until the stock is disposed of. It is only then that the income will appear on the taxpayer's Federal and New York tax returns as capital gain from the sale of the stock.

While the resolution of these two problems is of interest, neither is presented in the case before us. As indicated in the table set out above under Findings of Fact, petitioner engaged in a regular program of cashing out his stock options through simultaneous exercises and sales. These transactions had the effect of converting the stock options into a series of cash bonuses

treated as ordinary compensation income on the date received. The only issue in this case is whether the income from the exercises of options and sales of stock should be allocated to New York sources.

It appears that in ***Michaelsen*** the State Tax Commission and the courts did not need to address the issue of how stock option income should be allocated between New York sources and sources outside New York because the parties agreed to an allocation ratio for the petitioner's compensation for 1973, the year in which the income was recognized. There is no suggestion in the various opinions that a different method might be applicable to compensation derived from the stock options. The agreed ratio seems to represent days worked in New York divided by all work days in 1973. The decision of the State Tax Commission includes the following statement:

> A Statement of Audit Changes . . . explained that the . . . deficiency was due to adjustments made by the Audit Division to petitioners' 1973 return as follows:
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> > Increasing the ratio by which petitioners allocated their income in and out of New York State. The Audit Division denied petitioners' claim that six (6) days worked at home constituted days worked of necessity outside of New York State for petitioner James Michaelsen's employer. This denial increases petitioners' allocation ratio from 221/287 up to 227/287.
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> Petitioners have conceded and do not contest the Audit Division's increase in petitioners' allocation ratio . . . .

The version of the decision published by the Technical Services Bureau of the Department of Taxation and Finance (TSB-H-83[14]I, March 3, 1983) bears the legend, "This decision expresses the existing audit policy of the Department."

Items of income, gain, loss and deduction derived from or connected with New York sources include those items attributable to a business, trade, profession or occupation carried on in New York State (***see***, Tax Law § 631[b][1][B]). In determining New York source income, the regulations direct that a nonresident individual rendering personal services as an employee include the compensation for personal services if and to the extent that the individual's services were rendered in New York State (20 NYCRR 132.4[b]). The regulations (20 NYCRR 132.18) provide more detailed rules for measuring the extent to which services were performed in New York. They state in relevant part as follows:

> (a) If a nonresident employee . . . performs services for his employer both within and without New York State, his income derived from New York State sources includes that proportion of his total compensation for services rendered as an employee which the total number of working days employed within New York State bears to the total number of working days employed both within and without New York State. The items of gain, loss and deduction . . . of the employee attributable to his employment, derived from or connected with New York State sources, are similarly determined . . . .
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> (b) Where a nonresident employee . . . performs services both within and without New York State for only part of a taxable year, his income derived from New York State sources during that period includes only that portion of compensation received during the period he performs services both within and without New York State, multiplied by a fraction the numerator of which is the number of days he worked within New York State and the denominator of which is the number of days he worked both within and without New York State during the period he was required to perform service within and without New York State.

Although paragraph (a) does not state expressly the period over which the number of working days is to be calculated, paragraph (b) refers to the "taxable year" and several examples are provided in which the rule of paragraph (a) is applied to the days worked during the taxable year in which the income is realized.

Section 132.4(c) states, "If personal services are performed within New York State . . . the compensation for such services . . . constitutes income from New York State sources, regardless of the fact that . . . such compensation is received in a taxable year after the year in which the services were performed. . . ."

Another provision of possible relevance in this case is 20 NYCRR 132.24 which provides as follows:

> Sections 132.15 through 132.23 of this Part are designed to apportion and allocate to New York State, in a fair and equitable manner, a nonresident's items of income, gain, loss and deduction attributable to a business, trade, profession or occupation carried on partly within and partly without New York State. Where the methods provided under those sections do not so allocate and apportion those items, the department may require a taxpayer to apportion and allocate those items under such method as it prescribes, as long as the prescribed method results in a fair and equitable apportionment and allocation. A nonresident individual may submit an alternative method of apportionment and allocation with respect to items of income, gain, loss and deduction attributable to a business, trade, profession or occupation carried on partly within and partly without New York State. The proposed method must be fully explained in the taxpayer's New York State nonresident personal income tax return. If the method proposed by the taxpayer is approved by the department, it may be used in lieu of the applicable method under sections 132.15 through 132.22 of this Part.

On November 21, 1995, the Division issued a TSB-M-95(3)I to provide guidance on the tax treatment of certain stock options "received by nonresidents . . . who are or were employed in New York State." It states in relevant part as follows:

> Although Michaelsen resolved the issue concerning the total compensation that may be includable in the New York source income . . . 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 . . .

Methods of allocation similar to that prescribed in TSB-M-95(3)I are not unusual in the administration of other tax laws. For example, the Internal Revenue Service ("IRS") recently issued final regulations on the same issue which provide for an allocation based on a day count from the date of grant of the options to the date of vesting (***see***, Treas. Reg. § 1.861-4[b][2][ii][F], [G] *Example 6*, T.D. 9212, 2005-35 IRB 429 [Aug. 29, 2005], 70 FR 40663 [July 14, 2005]). Idaho uses the method adopted by the IRS (***see***, Idaho Reg. § 35.01.271 [2002]). California and Arizona appear to use the same method as that set forth in TSB-M-95(3)I–*i.e.*, a day count from grant to exercise (***see***, *Stock Option Guidelines*, Calif. Franchise Tax Bd. Pub. 1004 [Rev. 03-2005] at 6; Arizona HR 02-50). Nonetheless, the policy choices made by tax administrators in other jurisdictions have no direct bearing on our application of New York law to the present dispute. The issue in this case is not whether the method set out in TSB-M-95(3)I is wise or popular or whether it is "rational," "workable," "fair," or "equitable" as asserted by the Division (***see***, Division's brief on reargument, p. 6), but whether it is authorized under the laws of New York and the applicable regulations in effect during the taxable years at issue.

As noted above, the Administrative Law Judge found that TSB-M-95(3)I was a reasonable interpretation of the decision of the Court of Appeals in ***Michaelsen*** and was entitled to deference as a rational interpretation of a statute by an agency charged with administration of the statute. The issue of sourcing was not, however, presented in that case. Unlike the

Administrative Law Judge, we cannot find express or implied support in ***Michaelsen*** for an allocation based on a day count ratio over the years from grant to exercise when the facts before the State Tax Commission and the courts included an allocation based on a day count ratio for the year in which the income was realized. For reasons discussed later in this decision, we also disagree with the Administrative Law Judge's determination that TSB-M-95(3)I is entitled to deference.

In our decision dated May 12, 2005, we stated that income from petitioner's options was not taxable in New York merely because the options were granted while petitioner was employed in New York. We then rejected the Division's allocation method set out in TSB-M-95(3)I concluding that neither Tax Law § 631(c) nor 20 NYCRR 132.18 authorize imposing tax on income of a nonresident working in another state. Instead, we adopted an alternative method of apportionment and allocation as authorized by 20 NYCRR 132.24. That alternative method would allocate to New York sources the portion of the income realized by petitioner upon exercise of his options represented by the appreciation in the underlying stock while petitioner was a resident of New York. We based these calculations on reported public trading in the stock.

This case involves the two bases on which New York asserts jurisdiction to apply the personal income tax–*viz.*, residence and source. Residents are taxable on their worldwide income regardless of its source; nonresidents are taxed only on their New York source income. When a person's residence status changes, the Tax Law applies a closing-of-the-books method for allocating income and deductions between the period of residence and the period of nonresidence. Under this method, there is a short taxable year ending on the date of change and the taxpayer is required to compute income and deductions on the accrual method of accounting

for that period rather than the cash receipts and disbursements method generally used by individuals (***see***, Tax Law § 639; 20 NYCRR 154.10). Under general principles of tax accounting, no actual accrual of income from the options would be called for at the time petitioner left New York. The general standard for accruing income set forth in the Federal Income Tax Regulations reads as follows:

> Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income from the taxable year in which the determination can be made (Treas. Reg. § 1.451-1[a]).

By contrast, the method generally prescribed for determining the source of income from rendering personal services is proration based on the number of days worked in New York and the number of work days outside the state (***see***, 20 NYCRR 132.18[a]). The Division's regulations also provide for a closing of the books for sourcing purposes, but no accruals, where there are periods involving no work in New York (***see***, 20 NYCRR 132.18[b]).

We believe that the change of residence rules and the sourcing rules apply independently of each other and that a change in residence does not prevent the normal sourcing rules from applying to a period of nonresidence. We reject petitioner's argument that the "divide and accrue" rules of Tax Law §§ 638 and 639 limit the normal application of the sourcing rules that apply under section 631. The fact that section 639(b) excludes from its operation "items derived from or connected with New York sources" strongly implies that the sourcing rules operate before and independent of section 639. The decision of May 12, 2005 applies an accrual or mark-to-market accounting at the time of the change in residence for purposes of determining the

source of income, although not to accelerate income to the date of change as contemplated by Tax Law § 639. Thus, the decision imports to some extent a rule prescribed for allocating income between periods of residence and nonresidence and applies it to the determination of the source of income during a period of nonresidence. We have concluded upon further reflection that this departure from the normal sourcing methods set out in the regulations authorized by section 631 is ill-considered.

Another difficulty presented by the May 12, 2005 decision is that it requires a valuation of employee stock options at various points between grant and exercise, although a basic premise of the income taxation of such options is that they have no ascertainable market value prior to exercise. Under the Federal income tax rules governing the timing of income from options received as compensation for services rendered, income is taken into account when the option is exercised or disposed of, unless the option had a readily ascertainable value at the time of grant. If the value should become ascertainable at some later date, income will not be accelerated by that occurrence. Value is ordinarily not readily ascertainable unless the option itself is actively traded on an established market (***see***, Treas. Reg. § 1.83-7). The interim valuations required by our May 12, 2005 decision are inconsistent with these rules.

For the foregoing reasons, we have concluded that our decision of May 12, 2005 was in error to the extent stated above and is withdrawn. We now turn to the merits of the case afresh.

As noted above, the Tax Law imposes the personal income tax on the New York source income of a nonresident individual including income and deductions attributable to an occupation carried on in the state. In addition to the general grant of authority to issue regulations interpreting the Tax Law which is set forth in section 171(first), there is an additional

and specific authorization on the subject of the source of income from a business or occupation carried on partly within and partly without the state (***see***, Tax Law § 631[c]). It reads as follows:

> If a business, trade, profession or occupation is carried on partly within and partly without this state, *as determined under regulations* of the tax commission, the items of income, gain, loss and deduction derived from or connected with New York sources shall be *determined by apportionment and allocation under such regulations* (emphasis added).

Regulations issued under this plenary grant of authority (20 NYCRR 132.1 to 132.25) have the force and effect of law (***see***, ***Molina v. Games Mgt. Servs.***, 58 NY2d 523, 462 NYS2d 651). The general rules applicable to employees performing services partly within New York are set out in section 132.18(a) and (b), which are quoted in part above. These rules provide in paragraph (a) for an allocation based on a day count ratio during periods of work that include both work within the state and work without the state. The rule in paragraph (b) looks to the period in which "compensation [is] received" in determining whether the ratio set out in paragraph (a) applies or alternatively the period is simply eliminated from the calculation. The rigor of this methodology–counting days and applying a cash receipts accounting method– is tempered by section 132.4(c) and section 132.24. Section 132.4(c) provides that the sourcing rules apply to compensation "regardless of the fact that . . . such compensation is received in a taxable year after the year in which the services were performed" and section 132.24 provides for the possibility of alternative methods where the rules of, *inter alia*, section 132.18 do not apply "in a fair and equitable manner." There are also provisions in the regulations applying special rules for categories of nonresidents in situations where the general rules have been determined to produce inappropriate results. These include salespeople (§ 132.17), persons

performing duties on vessels (§ 132.19), recipients of pensions and other retirement benefits (§ 132.20), securities and commodity brokers (§ 132.21), and professional athletes (§ 132. 22).

The only situation for which the regulations provide a multiple year allocation method is the receipt of retirement payments that do not qualify as an exempt annuity (***see***, 20 NYCRR 132.20). There, the allocation is based on the ratio of compensation from New York sources to compensation from all sources for the portion of the current taxable year prior to retirement and each of the three taxable years immediately preceding the year of retirement. The compensation for each of these four periods is based on an annual day count and weighted by compensation that period. An example is provided in which the nonresident was to receive payments over ten years following retirement. (In the example, the weighting by compensation has no effect since the compensation is constant over the three-and-one-half year period.) Even in this situation, the day count ratio is "determined separately for each taxable year or portion of a year in accordance with the applicable provisions of section 132.17, 132.18 or 132.19" (20 NYCRR 132.20). We know of no other instance in which a multiple year allocation method is applied. The Division has stated that it is also unaware of any (***see***, Oral Argument on reargument, Tr., p. 15).

The rules and examples set out in section 132.18 of the regulations express, or strongly imply, an allocation based on work days within the taxable year in which the income is realized, subject to the flexibility afforded by section 132.4(c) and section 132.24. If the Division wishes to depart from the rules provided by those sections and create a separate set of new rules for identified special circumstances, we think such a change should be effected through legislation or adopted in regulations as was done in section 132.20 in the case of retirement payments and section 132.22 in the case of payments to professional athletes. We find it noteworthy that when,

as discussed above, the IRS undertook to issue rules on the same subject, it did so by proposing and then issuing in final form regulations subject to the publication and comment rules of the Federal Administrative Procedure Act.

As discussed above, the New York tax regulations provide in section 132.4(c) that compensation for personal services performed in New York has a New York source even if it is paid in a later year. Also, section 132.20 provides that retirement payments may have a New York source based on the place where services were performed in years prior to the years in which the retirement payments are received. Whether or not these provisions would survive challenge in the courts of another state, we have no reason to think that they are invalid under New York law (***see, e.g.***, ***Matter of Pardee v. State Tax Commn.***, 89 AD2d 294, 456 NYS2d 459 [profit sharing plan payment to nonresident]; ***Cerf v. Lynch***, 237 App Div 283, 261 NYS 231, ***affd*** 262 NY 549 [life insurance renewal commissions received after retirement]; ***Matter of Halloran***, Tax Appeals Tribunal, August 2, 1990 [sick leave payments]). The difficulty for the Division in the present case is not that it lacks statutory authority but that the position it espouses in TSB-M-95(3)I is inconsistent with its own regulations.

Petitioner's central argument is that the relevant provisions of the regulations are subparagraphs (a) and (b) of section 132.18 and that we need only to decide which of the two applies. Subparagraph (a) provides for an allocation of income based on days worked in New York. Subparagraph (b) provides that there is no such allocation when there are no New York work days in a period. Petitioner's position is that the Division is inappropriately attempting to apply subparagraph (a) by stretching the days included in the denominator of the fraction beyond a taxable year when in truth (b) is the governing provision since the compensation at issue was

received in a period in which no New York work was performed. We find petitioner's argument persuasive.

The Division argues that in issuing TSB-M-95(3)I it has "adopted an alternative method of apportionment and allocation" which is authorized by 20 NYCRR 132.24. That section states that where the methods provided in sections 132.15 through 132.23 do not allocate and apportion a nonresident's items of income, gain, loss and deduction in a fair and equitable manner, the Division "may require a taxpayer to apportion and allocate those items under such method as it prescribes, as long as the prescribed method results in a fair and equitable apportionment and allocation" (20 NYCRR 132.24). We read section 132.24 as accommodating ad hoc situations where the application of the general rules of the regulations would produce unfair or inequitable results (***see, e.g., Mark Silverman***, Advisory Opinion, October 26, 1992, TSB-A-92[10]I). It is easy to imagine situations in which the rules of paragraphs (a) and (b) of section 132.18, if not tempered by such a rule, could produce palpably unjust results. For example, if a nonresident employee worked from January to June exclusively at his company's New Jersey office and from July to December worked half his time in the New York office, section 132.18 would allocate 50% of his annual year-end bonus to New York while only 25% of his work for the year actually occurred in New York. If the bonus were paid in January of the following year, section 132.4(c) appears to permit the allocation based on the earlier year in which the work was done although not the year in which the income was realized.

TSB-M-95(3)I is clearly not such a special tailoring of allocation and apportionment to the peculiar circumstances of petitioner. It is a highly articulated set of rules of general application. The text, including allocation rules and examples, occupies eleven pages of single

spaced type and governs the tax treatment of residents and nonresidents and part-year residents who hold statutory stock options, nonstatutory stock options, restricted stock and stock appreciation rights. If section 132.24 were read so broadly as to give the authority of regulations to such a set of rules in the absence of compliance with the requirements of Article IV, § 8 of the New York State Constitution, Executive Law § 102(1), and the State Administrative Procedure Act, the validity of section 132.24 would be called into question. Accordingly, we conclude that the issuance of TSB-M-95(3)I does not constitute the adoption of an alternative method authorized by section 132.24. Similarly, we are unable to read section 132.4(c) so expansively as to authorize multiple year allocations such as would be typical of employee stock option plans, which frequently have a 10-year life (***see***, IRC § 422[b][3]). To read section 132.4(c) as broadly as the Division asserts would imply that the promulgation and adoption of section 132.20, providing a multiple year formula for taxing retirement payments, was an act of supererogation and that the same result might have been reached merely as an administrative interpretation of section 132.4(c). We do not agree.

The Division asserts that TSB-M-95(3)I does not violate the State Administrative Procedure Act because it is an interpretative or policy statement having no legal effect but is merely explanatory (***see***, State Administrative Procedure Act § 102.2[b][iv]; 20 NYCRR 2375.6[c]; Division's brief in opposition, pp.10-11). Yet the Division also argues that TSB-M-95(3)I is clothed in a dignity worthy of our deference because it is an interpretation or construction of a statute uttered by the agency authorized to administer the statute (***see***, Division's brief in opposition, pp. 12-13; Division's brief on reargument, pp. 7-8). In ***Lorillard Tobacco Co. v. Roth***, 99 NY2d 316, 756 NYS2d 108, the Court of Appeals recently rejected the

argument of the Division that a Technical Services Bureau Memorandum was entitled to deference observing that because a TSB Memorandum "serve[s] an advisory purpose, [it] lacks the precision of determinations generated through more formal Department action" (***Lorillard Tobacco Co. v. Roth***, ***supra***, 756 NYS2d, at 112). The court held that the issue in the case–*viz.*, whether cigarettes were sold "at less than cost" within the meaning of Tax Law § 484(a)(1)--was "a matter of statutory interpretation, not agency deference." The court quoted and applied the standard previously stated in ***Kurcsics v. Merchants Mut. Ins. Co.*** (49 NY2d 451, 426 NYS2d 454, which reads as follows:

> Where the interpretation of a statute or its application involves knowledge and understanding of underlying operational practices or entails an evaluation of factual data and inferences to be drawn therefrom, the courts regularly defer to the governmental agency charged with the responsibility for administration of the statute. If its interpretation is not irrational or unreasonable, it will be upheld. [citations omitted] Where, however, the question is one of pure statutory reading and analysis, dependent only on accurate apprehension of legislative intent, there is little basis to rely on any special competence or expertise of the administrative agency and its interpretive regulations are therefore to be accorded much less weight. And, of course, if the regulation runs counter to the clear wording of a statutory provision, it should not be accorded any weight (***Kurcsics v. Merchants Mut. Ins. Co.***, ***supra***, 426 NYS2d, at 458).

The issues in the present case do not involve an understanding of the physical or social sciences, obscure regulatory practices, complex markets or industries, expert analysis of voluminous factual data, or subtle policy determinations outside the competence of ordinary persons. Indeed, the issues are so purely legal in nature that the parties stipulated the facts and submitted the case to the Administrative Law Judge without a hearing. Applying the standard quoted above, we conclude that this is a case for our de novo interpretation of the applicable statute and regulations and not deference to TSB-M-95(3)I.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of E. Randall Stuckless and Jennifer Olson is granted;

2. The determination of the Administrative Law Judge is reversed;

3. The petition of E. Randall Stuckless and Jennifer Olson is granted; and

4. The Notice of Deficiency issued October 21, 2002 is modified to assess tax on income from options exercised after July 4, 1998, but is otherwise cancelled.

DATED: Troy, New York
August 17, 2006

/s/Charles H. Nesbitt
Charles H. Nesbitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/Robert J. McDermott
Robert J. McDermott
Commissioner