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 Christopher C. O'Brien, 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 petitioners' request, was heard on November 17, 2004 in Troy, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUES

I. Whether income received by petitioners from the exercise of stock options granted during petitioner E. Randall Stuckless's New York employment is subject to tax as New York source income, where the exercise occurred while petitioner E. Randall Stuckless was a nonresident.

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

[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.

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 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 granted 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

At the outset, the Administrative Law Judge addressed the law governing his determination. A personal income tax for each taxable year is imposed by New York State on a nonresident individual's taxable income which is derived from sources within New York State (Tax Law § 601[e]). The New York source income of a nonresident individual 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 (Tax Law § 631[a]). 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 (Tax Law § 631[b][1][B]). Where the personal services are performed both within and without New York State, the portion of the compensation attributable to the services performed within New York State must be determined in accordance with sections 132.16 through 132.18 of the regulations.

The Administrative Law Judge noted that it is petitioner's burden to prove that the income in question was not secured or earned pursuant to activities connected with or derived from New York sources. In this regard, the controlling factor is the consideration given by petitioner in exchange for the right to the income at issue (***Matter of Laurino***, Tax Appeals Tribunal, May 20, 1993). The question is what did petitioner give "in exchange for the right to the income" (***Matter of Haas***, Tax Appeals Tribunal, April 17, 1997). Where the consideration has no connection to New York, the income will not be subject to tax by the State (***Matter of Donohue v. Chu***, 104 AD2d 523, 479 NYS2d 889).

The Administrative Law Judge found that the stock options awarded to petitioner on November 4, 1991 and July 7, 1992 under the Stock Option Plan were secured or earned through petitioner's Microsoft employment in New York and were properly considered New York source income for the years at issue. Furthermore, the Administrative Law Judge noted, the Court of Appeals has held that employee stock options for either past services or incentive for future services are compensation attributable to the employee's business, trade, profession or occupation carried on in *New York* (Tax Law § 632[b][1]; ***see***, ***Matter of Michaelsen v. New York State Tax Commn.***, 67 NY2d 579, 505 NYS2d 585). The Administrative Law Judge found

that ***Michaelsen*** is controlling in the instant matter and rejected petitioner's contention that awards under the Stock Option Plan were not subject to New York income tax.

The Administrative Law Judge also rejected petitioner's argument that his rights did not vest until he exercised the options while a resident in Washington State in 1997 and 1998 as not supported by the evidence in the record. The Administrative Law Judge noted, with regard to "vesting," that the Stock Option Plan provides:

> "[a]n option holder's right to exercise his or her stock option generally vests in increments over time. Vesting schedules are set by the Board, and may vary among option holders. Please refer to your own stock option grant agreement to determine your vesting schedule."

The Administrative Law Judge found that since the stock option grant agreement itself is not in the record, the Stock Option Plan's provision that vesting occurs over time supports the conclusion that petitioner, while an employee in New York State prior to his move to Washington, had a vested interest in the ISO's granted by Microsoft in 1991 and 1992.

The Administrative Law Judge pointed out that the Court of Appeals in 1986 held that the stock option income of a nonresident who worked in New York was *not* investment income 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***). The Court looked to Federal treatment of employee stock options for guidance in determining proper valuation of the compensation attributable to certain employee stock options under Tax Law § 632, stating:

> An option granted, as here, pursuant to a qualified employee stock option plan is not transferable, . . . (Internal Revenue Code § 422[b][6]), and cannot have a **readily ascertainable fair market value** when it is granted (Treas Reg [26 CFR] § 1.83-7[b][1],[2]). 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 (Treas Reg [26 CFR] § 1.83-7[a]). This gain is characterized by Federal authorities as compensation for services performed (***Commissioner v. LoBue***, 351 US 243, 247, 76 S.Ct. 800, 803, *supra*; Treas Reg [26 CFR] § 1.422-1[b][3], example [2]). 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 (***Matter of Michaelsen v. New York State Tax Commn.***, ***supra***, 505 NYS2d, at 588, bold emphasis added).

The ***Michaelsen*** Court went on to dismiss taxing as compensation only the difference between the fair market value of the stock on the date the option is first exercisable and the option price, since that would leave much of the compensation to the employee untaxed. The Court noted that the value of an option on the date it became exercisable is greater than the difference between the option price and the fair market value as of that date and is properly taxed as the New York compensation of a nonresident. The Court reasoned, however, that:

> Because the option [at issue] is not transferable (Internal Revenue Code [former] § 422[b][6]), this extra value cannot be adequately measured on the date the option becomes exercisable (Treas Reg [26 CFR] § 1.83-7[b][2]). Thus, in conformity with Federal law, we 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. Accordingly, . . . this income is taxable in New York under Tax Law § 632(b)(1)(B) (***Matter of Michaelsen v. New York State Tax Commn.***, ***supra***, 505 NYS2d, at 588-589, emphasis added).

The Administrative Law Judge noted that the ***Michaelsen*** Court's holding relied on Federal tax law and the Court used the phrase "readily ascertainable fair market value" in the context of Internal Revenue Code § 83 and the regulations promulgated thereunder. The term "readily ascertainable," for purposes of Internal Revenue Code § 83, is defined as an option that is not

actively traded on an established market and is not transferable by the owner of the option and does not, by definition, have a readily ascertainable fair market value (Treas Reg [26 CFR] § 1.83-7[b][2]). The Administrative Law Judge found that the options at issue here were not actively traded, were not transferable and did not have a "readily ascertainable fair market value." Therefore, the Administrative Law Judge concluded that the ***Michaelsen*** decision is applicable to the matter at hand and the Division properly valued the options at issue as of the date of exercise.

The Division issued, on November 21, 1995, a Technical Services Bureau Memorandum, TSB-M-95(3)I,[2] to provide "guidance on the New York tax treatment of stock options, restricted stock and stock appreciation rights received by nonresidents . . . who are or were employed in New York State." After providing a summary of the 1986 Court of Appeals decision in ***Michaelsen***, this 1995 Memorandum described how a nonresident's employee compensation from the exercise of stock options should be allocated to New York as follows:

> Although ***Michaelson*** [sic] resolved the issue concerning the total compensation that may be includable in the New York source income [footnote omitted] 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

[2]Hereinafter, referred to as the "Memorandum" or the "M."

> the compensable period, and whose denominator is the total days worked by the employee both inside and outside the state during the compensable period . . . (TSB-M-95[3]I).

The Administrative Law Judge stated that TSB-M-95(3)I was issued in response to the ***Michaelsen*** decision, and based upon Tax Law § 631(c) and 20 NYCRR 132.18, which provide that income earned by a nonresident employee is to be allocated based upon the number of days the employee worked inside and outside the state. The Memorandum provides that where stock options are granted to a taxpayer in New York and the taxpayer subsequently has a change of residence outside New York State, the amount of any gain includable in New York source income is limited to the appreciation in the value of the stock from the date of grant to the date of exercise, and any allocation is based on days worked inside and outside the state determined as if the taxpayer were a nonresident from the time the option was granted until it was exercised. The Administrative Law Judge found the Technical Services Memorandum to be a reasonable interpretation of the ***Michaelsen*** decision, the Tax Law and the Regulations as they apply to nonresident income in the form of stock options earned while the taxpayer was a resident of New York State.

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 penalties.

ARGUMENTS ON EXCEPTION

Petitioner presents the same arguments as were presented below. He argues that the Administrative Law Judge erred in applying the decision in ***Michaelsen*** and the TSB-M-95(3)I to this case. Petitioner argues that the Memorandum was improperly issued and, in any event,

has no application to this fact situation. Petitioner also argues that the Division erred in finding that the gain on his stock options was secured and earned solely through his New York employment. Petitioner urges that the Administrative Law Judge should have treated his New York employment as terminated when he moved to the State of Washington in 1996. Petitioner also maintains that the Administrative Law Judge should have granted collateral estoppel as to a prior unrelated tax determination by an administrative law judge. Petitioner claims that penalties should have been abated.

The Division claims that the determination of the Administrative Law Judge was correct and should be sustained.

OPINION

Stock options are compensation and are taxable as such (***Commissioner v. LoBue***, ***supra***; ***Matter of Michaelsen v. New York State Tax Commn***., ***supra***). To the extent that they were compensation in connection with petitioner's employment in New York, their value is taxable in this State (***Matter of Michaelsen v. New York State Tax Commn., supra***).

A personal income tax for each taxable year is imposed by New York State on a nonresident individual's taxable income which is derived from sources within New York State (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* (Tax Law § 631[a]). 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 (Tax Law § 631[b][1][B]). The Division's regulation (20 NYCRR 132.18) provides, in part, as follows:

> *Earnings of nonresident employees and officers.*
>
> (a) If a nonresident employee (including corporate officers . . .) 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. . . . However, any allowance claimed for days worked outside New York State must be based upon the performance of services which of necessity, as distinguished from convenience, obligate the employee to out-of-state duties in the service of his employer. In making the allocation provided for in this section, no account is taken of nonworking days, including Saturdays, Sundays, holidays, days of absence because of illness or personal injury, vacation, or leave with or without pay.

In determining New York source income, tax regulations also direct that a nonresident individual, rendering personal services as an employee, include the compensation for personal services entering into the individual's Federal adjusted gross income, *but only if, and to the extent that, the individual's services were rendered in New York State* (20 NYCRR 132.4[b]). In a hearing before the Division of Tax Appeals, the petitioner has the burden of proving the deficiency assessment improper (Tax Law § 689[e]), and if there are any facts or reasonable inferences from the facts to support the Commissioner's determination, the assessment should be confirmed ***(Matter of Great Lakes Dredge & Dock Co. v. Department of Taxation & Fin.,*** 39 NY2d 75, 382 NYS2d 958, ***cert denied*** 429 US 832, 50 L Ed 2d 97; ***Matter of Grace v. New York State Tax Comm.,*** 37 NY2d 193, 371 NYS2d 715, ***lv denied*** 37 NY2d 708, 375 NYS2d 1027; ***Matter of Young v. Bragalini,*** 3 NY2d 602, 170 NYS2d 805; ***People ex rel. Hull v. Graves,*** 289 NY 173).

The central issue in this matter is whether a nonresident's gain from the exercise of stock options in another state is subject to New York personal income tax, when during the year of exercise, the nonresident neither lived nor worked in New York.

Not until the 1986 Court of Appeals decision in ***Matter of Michaelsen v. New York State Tax Commn.*** (***supra***) was it decided that the stock option income of a nonresident who worked in New York was compensation attributable to a "business, trade, profession or occupation carried on" in New York so that it was properly subject to New York personal income tax.

The question presented is whether the stock options here are to be valued based on the Court of Appeals decision in ***Michaelsen*** and, if so, does that Court's decision require a multi-year "compensable period" for allocation of the gain as prescribed in the Division's TSB-M-95(3)I. Since ***Michaelsen*** is central to our decision, we address it here in some detail.

James A. Michaelsen worked in New York City as an executive for Avon Products, Inc. ("Avon"). There is no indication in the record that he ever worked anywhere else but New York. While working in New York, Michaelsen was granted stock options in Avon capital stock pursuant to a qualified employee stock option plan in 1968. On March 13, 1972, he exercised some of his stock options by purchasing 3,000 shares of Avon stock, and approximately a year later, on February 22, 1973, he exercised additional stock options by purchasing 3,000 more shares. Subsequently, in 1973, he sold all 6,000 shares and reported a gain of $179,761.00 for 1973 Federal income tax purposes. Mr. Michaelsen, a resident of Connecticut, did not report any part of that gain of $179,761.00 on his nonresident New York income tax return for 1973.

The State Tax Commission's decision in ***Matter of Michaelsen*** (State Tax Commn., February 4, 1983, ***confirmed Michaelsen v. New York State Tax Commn.***,122 Misc 2d 824, 471

NYS2d 789, ***revd*** 107 AD2d 389, 486 NYS2d 479*,* ***mod*** *67* NY2d 579, 505 NYS2d 585)*,* treated the taxpayer's stock options as a form of compensation from Avon, his New York employer, granted to him "for past services to Avon or as an incentive for future services to Avon." Therefore, according to the Commission, the gain he recognized from his sale of the 6,000 shares of Avon stock in 1973 "constitutes compensation and is connected with New York sources." The Commission directed that such income was to be included in Mr. Michaelsen's New York adjusted gross income for 1973.

The Supreme Court in ***Michaelsen v. New York State Tax Commn.*** (122 Misc 2d 824, 471 NYS2d 789, ***revd*** 107 AD2d 389, 486 NYS2d 479, ***mod*** 67 NY2d 579, 505 NYS2d 585), dismissed his Article 78 proceeding to annul the State Tax Commission's decision noting that the State Tax Commission's decision had a rational basis because:

> [t]here was no evidence indicating that the options through which the stock was acquired were issued other than as a form of compensation to petitioner James Michaelsen for either past services or incentive for future services to his [New York] employer (***Michaelsen v. New York State Tax Commn., supra***, 471 NYS2d, at 790).

The Supreme Court rejected Mr. Michaelsen's argument that the stock option income was not subject to New York personal income 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" (***Michaelsen v. New York State Tax Commn., supra***, 471 NYS2d, at 790). The Supreme Court did not address the allocation percentage to be used in calculating the portion of the stock option income subject to New York personal income tax.

The Appellate Division's decision (later modified by the Court of Appeals) in ***Matter of Michaelsen v. New York State Tax Commn.*** (107 AD2d 389, 486 NYS2d 479, ***mod*** 67 NY2d

579, 505 NYS2d 585), declared that the State Tax Commission and Supreme Court by affirming the Commission were incorrect in treating the "appreciation of the market value of the stock in Avon" as connected with the rendering of services by Mr. Michaelsen to Avon in New York (***Matter of Michaelsen v. New York State Tax Commn., supra,*** 486 NYS2d, at 481). Rather, according to the Appellate Division, "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., supra***, 486 NYS2d, at 481).

The Court of Appeals rejected the Appellate Division's position in its decision in ***Matter of Michaelsen v. New York State Tax Commn.*** (***supra***), and pointed out the following error in the Appellate Division's decision:

> 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).[3]

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:

> [F]or 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" (***Matter of Michaelsen v. New York State Tax Commn., supra***, 505 NYS2d, at 589).

The Court of Appeals **did not** address the allocation of the tax to be applied to Mr. Michaelsen's stock option income.

As noted by the Administrative Law Judge, 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." This memorandum states, in part, that although the Court of Appeals in ***Michaelsen*** resolved the issue concerning the total compensation that may be includable in the New York source income of a nonresident, the Court:

> [D]id 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 [by the Division] over which the employee's performance of services will be measured (*compensable period*).

This 1995 Memorandum was purportedly issued in response to the 1986 ***Michaelsen*** decision and cites as authority Tax Law § 631(c) and 20 NYCRR 132.18.

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[3]This is not an issue in the instant matter, since the dates the options were exercised are also the date the stock was sold.

The Division appears to argue that the decision of the Court of Appeals in ***Michaelsen*** *required* that a nonresident's stock option income be allocated to New York based upon a date of grant to date of exercise allocation period rule which the Division adopted in TSB-M-95(3)I. However, based upon the above analysis of the 1986 Court of Appeals decision in ***Michaelsen***, the Division's position is rejected. It was not the *dates* the options were granted and the dates of exercise that the Court of Appeals treated as significant, but the *values* attaching to the stocks on the grant and exercise dates. The Court was trying to measure the value of the taxpayer's gain; it was not trying to measure time. The Court of Appeals decision *did not require* the grant to exercise allocation period rule adopted by the Division in its Memorandum. Of course, a multi-year period was implicit in ***Michaelsen***, since the date of the option was 1968 and the dates of exercise were 1972 and 1973. But the Court never emphasized the option "date" or the exercise "dates," but rather the "value" on the option date and the "fair market value" on the exercise date in measuring the gain. We also note that Michaelsen, unlike petitioner here, was at all relevant times employed in New York.

The Administrative Law Judge held that to prevail in this matter, petitioner must show that the income in question was not secured or earned pursuant to activities connected with or derived from New York sources (***see***, ***Matter of Laurino***, ***supra***). In making this determination, the controlling factor is the consideration given by petitioner in exchange for the right to the income at issue (***Matter of Laurino***, ***supra***, ***citing Matter of Halloran***, Tax Appeals Tribunal, August 2, 1990). In other words, "it is necessary to examine what petitioner gave up in exchange for the right to the income at issue" (***Matter of Haas***, ***supra***). Where the consideration

has no connection to New York, the income will not be subject to tax by the State (***Matter of Donohue v. Chu***, ***supra***).

The Administrative Law Judge went on to find that the stock options awarded to petitioner on November 4, 1991 and July 7, 1992 under the Stock Option Plan were secured or earned through petitioner's Microsoft employment and were, therefore, properly considered New York source income for the years at issue. The Plan provided that its purpose was to attract and *retain* the best available personnel for positions of substantial authority and to *provide additional incentive* to such individuals by aligning employee financial interests with long-term shareholder value. From this language, the Administrative Law Judge concluded that the award of the stock options under the plan indicated an intent that the options be treated as compensation for services rendered to the company. The Administrative Law Judge then states, "the Court of Appeals has held that employee stock options for either past services or incentive for future services are compensation attributable to the employee's 'business, trade, profession or occupation carried on in New York' (Tax Law § 632[b][1]; ***see***, ***Matter of Michaelsen v. New York State Tax Commn.***, 67 NY2d 579, 505 NYS2d 585)" (Determination, conclusion of law "C") and concludes that the stock option gain here was to be sourced to New York. We disagree. First, we find that the Administrative Law Judge's reliance on ***Matter of Halloran*** (***supra***) is misplaced. The taxpayer in ***Halloran*** lived in Connecticut and his place of employment was New York. The same is true in ***Michaelsen***. Second, while we agree with the Administrative Law Judge that petitioner secured his stock options while employed in New York and that accretions to the value of the stock while he lived and worked in New York are properly subject to New York tax, we do not agree that because the options were granted while petitioner was

employed in New York that ***Halloran*** extends the embracing arms of the New York Tax Law to accretions in value of the stock earned as compensation during years when petitioner worked and lived in another state. Where the consideration, i.e., petitioner's continued employment with Microsoft in Washington State, has no connection to New York employment, the income will not be subject to tax by the State (***see***, ***Matter of Donohue v. Chu***, ***supra***). The increase in value of the stock during the period petitioner worked in Washington represented part of his compensation for his work there and is not attributable to petitioner's employment in New York.

We disagree with petitioners' claim that the Division improperly issued the above referenced Memorandum. The Memorandum is not a regulation and does not carry the force and effect of law. It is an informational and interpretive document to give guidance to taxpayers. However, while the manner of its issuance is not problematic for us, we do not regard it as legal authority. Further, the Memorandum has no application to the facts of this case since petitioner neither lived nor was employed in New York in 1997.

Petitioner was not a nonresident employee performing services for his employer in New effect York State during the period September 1, 1996 through July 4, 1998. During that period, petitioner both lived and worked in the State of Washington. The record does not reflect that he retained any connection with the State of New York after September 1, 1996.[4] Neither Tax Law § 631(c) nor the above regulation (20 NYCRR 132.18) make provision for imposing tax on the income of a nonresident working in another state.

The consideration given by petitioner in return for the ISO's were his employment and his *continued employment* with Microsoft. The fact that petitioner worked and lived in New York at

[4]Until he moved back to New York in July 1998.

the times the ISO's were granted clearly provides nexus for New York to assert personal income tax on any accretions in value to the stock options during those years when petitioner worked and lived in New York, i.e., the accretions in value to the stock options represent a portion of petitioner's compensation for the periods he worked in New York (***see***, ***Matter of Michaelsen v. New York State Tax Commn.***, ***supra***), properly sourced and subject to personal income tax in New York through September 1, 1996. The proper method of valuing the compensation derived from a stock option that, as here, has no 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, but the gain is not *recognized* until the stock is sold (***see***, ***Matter of Michaelsen v. New York State Tax Commn.***, ***supra***). In this case, the stock option was exercised and the stock was sold on the same day. Accordingly, we agree, pursuant to ***Michaelsen***, that the Division properly valued the options at issue on the dates of exercise. Since the stock was sold on the same days as exercise of the option, the gain was recognized for tax purposes on the exercise dates. However, we reject the Division's method of allocating the gain to New York.

As noted earlier, petitioner worked in Washington during 1997 and part of 1998, but the stock options were exercised there (the gain realized) and the sale of the stock occurred (the gain recognized) there. A portion of that gain represented part of petitioner's compensation for his work in Washington State. Since current regulations (20 NYCRR 132.18) and TSB-M-95(3)I do not apply to the facts in this case, the Division could have adopted, as we do here, an alternative method of apportionment and allocation (***see***, 20 NYCRR 132.24). Petitioner was employed in New York until September 1, 1996 and any accretion in value to the stock options, from the date of grant, through the dates of exercise and sale would be part of petitioner's compensation for

services to his employer in New York and clearly be subject to tax by the State of New York.[5] Accretions in value to the stock options occurring while petitioner was employed in the State of Washington, are part of petitioner's compensation for services rendered there and are not subject to New York State tax.

Petitioner argues that his rights did not vest until he exercised the options while a resident in Washington State in 1997 and 1998. The Administrative Law Judge found that the Stock Option Plan's provision that vesting occurs over time supported his conclusion that while an employee in New York State prior to his move to Washington, petitioner had a vested interest in the ISO's. We agree. However, we also agree with petitioner that these vesting rights were at all times *subject to* the forfeiture provisions of the Plan should his employment with Microsoft terminate. If petitioner's employment ceased while in Washington State, his stock options were subject to forfeiture and their value would be zero.

We agree with petitioner that his New York employment terminated on the date he moved to Washington and that the fair market value of the stock on the date he moved out of New York must be used to determine the gain realized for New York State income tax purposes. Our holding is consistent with the purpose of the Tax Law and regulations, which attempt to allocate to New York the compensation derived from New York employment. It is also consistent with the decision in ***Michaelsen***, which held that the gain derived from stock options is realized when the option is exercised, and valued by subtracting the option price from the fair market value of the stock at the time of exercise.

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[5]Petitioners do not contest the fact that they would be subject to tax for periods after their return to New York in July 1998.

Petitioner claims that the Division is collaterally estopped from arguing that the allocation method provided in TSB-M-95(3)I is applied consistently to all similarly situated taxpayers, creating in this case a discriminatory application because this same issue was addressed in a previous unrelated Administrative Law Judge determination. The Administrative Law Judge here properly rejected this claim. We affirm the Administrative Law Judge on this issue for the reasons stated in his determination.

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. Petitioner claims that reasonable cause exists for the abatement of these penalties because it was not foreseeable by him that a portion of his gain on ISO stock sales while a resident of Washington State and working for an employer there, would be treated as New York source income. As we have already held that TSB-M-95(3)I has no application to the facts of this case, we reverse the Administrative Law Judge on this issue and conclude that penalties must be cancelled.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of E. Randall Stuckless and Jennifer Olson is granted to the extent that tax asserted on accretion in value to petitioners' stock options accruing during the period beginning September 1, 1996 and ending July 4, 1998 together with all penalty and interest is cancelled, but is otherwise denied;

2. The determination of the Administrative Law Judge is reversed to the extent indicated in paragraph "1" above, but is otherwise sustained;

3. The petition of E. Randall Stuckless and Jennifer Olson is granted to the extent indicated in paragraph "1" above, but is otherwise denied; and

4. The Notice of Deficiency issued October 21, 2002 is modified in accordance with paragraph "1" above, but is otherwise sustained.

DATED: Troy, New York
May 12, 2005

/s/Donald C. DeWitt
Donald C. DeWitt
President

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