STATE TAX CONSIDERATIONS FOR STOCK PLAN PROFESSIONALS

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A. William Caporizzo
Kimberly B. Wethly
Julie Hogan Rodgers
WilmerHale

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Today's Topics

Overview of how states tax optionees

- Residents vs. nonresidents
- State in which the services are performed vs. state in which the income is recognized
- Double taxation and tax credits

Overview of state tax considerations for employers

- Withholding
- Apportionment
- Deductions

State Taxation of Optionee

- Most states follow the federal income tax treatment of stock options.
- Pennsylvania taxes ISOs in the same manner as NSOs.
- Some states, such as Hawaii and Rhode Island, provide special rules as an incentive to certain employees and employers.

State Taxation of Residents/Nonresidents

- States tax their residents on all of their income regardless of its source.
- States tax nonresidents only on their income from sources within the state:
  - which includes income from employment in the state,
  - but generally does not include income from intangible personal property (such as stock).

Example 1: Tax Treatment in Optionee's State of Residence

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

Example 2: Tax Treatment in State Where Optionee Performs Services

- Assume Tom received the NSO from a company for which he performed services in Rhode Island from the grant date of the NSO to the exercise date.
- During that period, Tom performed no services in Massachusetts.
- Assume that the NSO does not qualify for special tax treatment in Rhode Island.

Example 3: What if the option is an ISO?

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

What if the optionee performs services in more than one state?

- Compensation income is allocated to a state to the extent that the income is reasonably attributable to services performed in the state.
- Possible methods of allocation for stock option income:
  - Time worked during the allocation period.
  - Total compensation received during the allocation period.
  - What is the allocation period?

Example 4: Performance of Services by Optionee in More than One State

- Assume Matt moved to Arizona on May 28, 2005 and continued to perform services in Arizona for the company that granted him the ISO until May 28, 2006, the date that the ISO vested and he exercised the ISO.
- Example 5: What if the option were an NSO?

Example 6: Performance of Services by Optionee in More than One State

- What if the NSO vested on May 28, 2005 and on the same date Matt terminated his employment with the company and moved to Arizona where he began work for a new employer?

Example 7: What if the option vests upon Matt moving to Arizona?

- Assume Matt's ISO vested on May 28, 2005, the date that he moved to Arizona.
- Matt continued to perform services in Arizona for the company that granted him the ISO until May 28, 2006, the date that he exercised the ISO.

Example 8: What if Matt sells the stock at less than the fair market value on the exercise date?

- Assume Matt sells the stock acquired upon exercise of the ISO for $45 per share.
- The fair market value of the stock on the exercise date was $50 per share.
- The exercise price was $5 per share.

- Example 9: What if Matt sells the stock for less than $5 per share?

Availability of Tax Credits to Mitigate Double Taxation

- Where income is subject to taxation in more than one state, a tax credit may be available in one of the states to relieve the double taxation.
- Some states have reciprocal agreements with other states to prevent double taxation.

Example 10: Tax Credit in Resident State

- Tom, a resident of Massachusetts, exercises an NSO on May 1, 2006 and purchases 10 shares of stock, with a value of $10 per share, for $1 per share.
- On June 30, 2007, Tom sells the stock for $15 per share.
- Tom received the NSO from a company for which he performed services in Rhode Island from the grant date of the NSO to the exercise date.

Example 11: Tax Credit in Nonresident State

- Matt, a resident of California, was granted an ISO for 20 shares of stock with an exercise price of $5 per share.
- Matt exercised the ISO while a resident of California, receiving stock with a fair market value of $50 per share.
- Matt retired and moved to Arizona and sold the stock for $100 per share in a disqualifying disposition.

Example 12: Pennsylvania Taxation of ISOs May Prevent Use of Credit

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

State Taxation of Qualifying Dispositions of ISOs

- Long-term capital gain recognized upon the qualifying disposition of an ISO generally is only taxable in the optionee's state of residence.
- Some states (such as New York, Connecticut, Idaho, Maine and Wisconsin) tax nonresidents on the compensation element of income recognized upon a qualifying disposition to the extent it is attributable to services performed in the state.

Example 13: Qualifying Disposition of ISO

- Assume Matt sold the 20 shares of stock acquired (for $5 per share) upon exercise of the ISO for $100 per share in a qualifying disposition.

Example 14: Qualifying Disposition of ISO

- Assume Matt was a resident of Idaho prior to moving to Arizona, and from the grant date to the exercise date, Matt only performed services in Idaho for the company that granted him the ISO.

State AMT

- Some states (such as California) have an AMT, which also could result in double taxation of income.
- Where two states are involved, double taxation may occur because the AMT will be due in one state in a different year from the date the regular tax is due in the other state.

Withholding Tax Issues

- Most states follow the federal income tax withholding rules with respect to income from stock options.
- Employers subject to withholding in a state generally are required to withhold state income tax from income paid to an employee if:
  - the income is taxable by the state, and
  - federal income taxes must be withheld from the income.
- Pennsylvania requires withholding with respect to income recognized upon exercise of an ISO.

Example 17: Withholding on ISOs

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

Multi-State Withholding Issues

- If there are multiple states involved, the employee may have compensation income in both his resident state and nonresident state. Withholding in both states could result in excessive withholding, after application of the various mechanisms to avoid double taxation.
- To avoid this result, some states allow employers to reduce their withholdings to reflect any taxes withheld for the benefit of other states.
- Reciprocal agreements among states often provide additional mechanisms to avoid excessive withholding.

Inclusion of Option Income in the Payroll Factor for Apportionment Purposes

- Most states include a payroll-related factor in their apportionment formulas.
- Generally, the compensation income from options is included in the payroll factor in the year the employee recognizes the income.
- Generally, the compensation is only included in the numerator of one state's payroll factor.

Employer Deductions

- An employer is generally entitled to a compensation deduction for state income tax purposes at the same time and in the same amount as for federal income tax purposes.
- Employers are entitled to deduct the compensation income recognized by optionees upon the exercise of ISOs for Pennsylvania tax purposes.

Summary

- Most states follow the federal tax treatment of stock options, but there are exceptions.
- Complex issues may arise when multiple states are involved due to an optionee:
  - Residing and working in different states.
  - Performing services in more than one state.
  - Moving from one state to another state.
- Stock options may affect the employer's state income tax liability.

Contact Information

Bill Caporizzo

- (617) 526-6411
- william.caporizzo@wilmerhale.com

Kimberly B. Wethly

- (617) 526-6481
- kim.wethly@wilmerhale.com

Julie Hogan Rodgers

- (617) 526-6543
- julie.rodgers@wilmerhale.com