STATE AND LOCAL TAX CONSIDERATIONS FOR STOCK PLAN PROFESSIONALS

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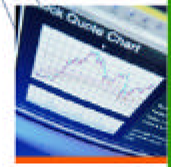

Today's Topics

> 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

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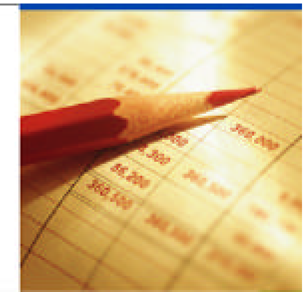
State Taxation of Optionee

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



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:
  - includes income from employment in the state,
  - generally does not include income from intangible personal property (such as stock).

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

- Nomar, a resident of Massachusetts, exercises an NSO on May 1, 2002 and purchases 10 shares of stock, with a value of $10 per share, for $1 per share.
- On June 30, 2003, Nomar sells the stock for $15 per share.
- Nomar 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 Nomar 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, Nomar 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, 1999, Barry, a resident of California, was granted an ISO for 20 shares of stock with an exercise price of $5 per share.
- On May 28, 2001, the ISO vested, and Barry exercised the ISO receiving stock with a fair market value of $50 per share.
- Barry retired and moved to Arizona. On April 1, 2002, Barry sold the stock for $100 per share.
- From the grant date of the ISO through the exercise date, Barry 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 compensable period.
- Total compensation received during the compensable period.
- What is the compensable period?

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

> Assume Barry moved to Arizona on May 28, 2000 and continued to perform services in Arizona for the company that granted him the ISO until May 28, 2001, the date that the ISO vested and he exercised the ISO.

Example 5:

> What if the option were an NSO?

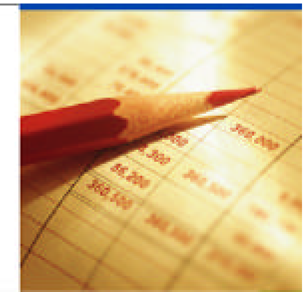
Example 6:

> What if the NSO vested on May 28, 2000 and on the same date Barry terminated his employment with the company and moved to Arizona?

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

- Assume Barry's ISO vested on May 28, 2000, the date that he moved to Arizona.
- Barry continued to perform services in Arizona for the company that granted him the ISO until May 28, 2001, the date that he exercised the ISO.

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



- Assume Barry 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.
- What if Barry sells the stock for less than $5 per share?

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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.

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Example 9: Tax Credit in Resident State

- Nomar, a resident of Massachusetts, exercises an NSO on May 1, 2002 and purchases 10 shares of stock, with a value of $10 per share, for $1 per share.
- On June 30, 2003, Nomar sells the stock for $15 per share.
- Nomar 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 10: Tax Credit in Nonresident State

> Barry, a resident of California, was granted an ISO for 20 shares of stock with an exercise price of $5 per share.

> Barry exercised the ISO while a resident of California, receiving stock with a fair market value of $50 per share.

> Barry retired and moved to Arizona and sold the stock for $100 per share in a disqualifying disposition.

Example 11: Pennsylvania Taxation of ISOs May Prevent Use of Credit

- Roberto, a resident of Pennsylvania, was granted an ISO on July 4, 1999 to purchase 10 shares of stock with an exercise price of $3 per share.
- On July 4, 2000, the stock had a fair market value of $10 per share, and Roberto exercised the ISO.
- In February of 2001, Roberto moved to New York and sold the stock for $20 per share.

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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, 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 12: Qualifying Disposition of ISO

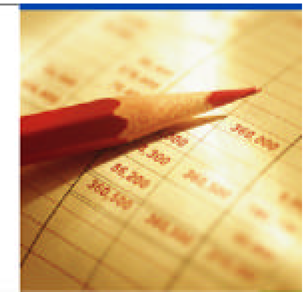
- Assume, in Example 10, Barry sold the 20 shares of stock acquired (for $5 per share) upon exercise of the ISO for $100 per share in a qualifying disposition

Example 13:

> Assume Barry was a resident of New York (rather than California) prior to moving to Arizona and only performed services in New York for the company that granted him the ISO. The fair market value on the date of exercise was $50 per share.

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.



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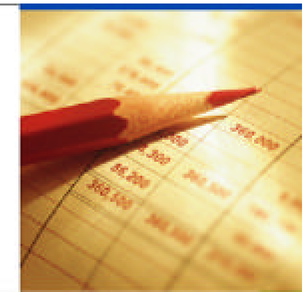
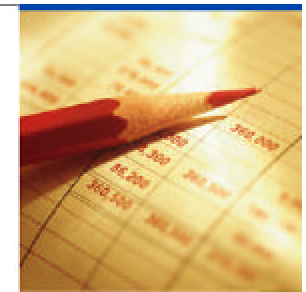


Withholding Tax Issues

- 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.

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.

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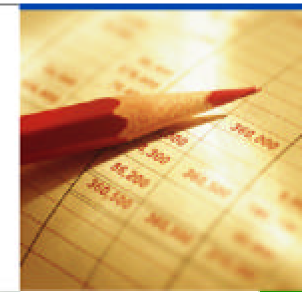
Inclusion of Option Income in the Payroll Factor for Apportionment Purposes

- 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.

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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.

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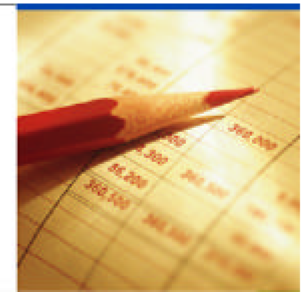

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