STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Legal Branch

Technical Advice Memorandum –2001-0463
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Source of Income From Incentive Stock Options

Requested By:	Winston Mah Chief, Audit Division
Request Date:	October 1, 2001
TAM Author:	Richard Gould/Natasha Page
Phone Number	845-6729
Fax Number	845-3648

QUESTION PRESENTED:

The question has been asked whether California will follow the New York decision in *Michaelsen v. New York State Tax Commission* (1986) 67 N.Y. 2d 579 (hereinafter "*Michaelsen*"). In *Michaelsen*, the court stated that for both qualified and nonqualified dispositions of qualified (or incentive) stock options, New York treats a portion of the gain as compensation for services for purposes of sourcing.[1]

CONCLUSION:

For the reasons expressed below, California will not adopt the rule expressed in *Michaelsen* as applied to qualifying dispositions of incentive stock options ("ISOs"). All gain from a qualifying disposition of an ISO should be characterized as gain from the sale or disposition of intangible personal property having a source in the taxpayer's state of residence at the time of the disposition of the stock.

ANALYSIS AND DISCUSSION:

Michaelsen

In *Michaelsen,* New York's highest court (Court of Appeals) held that the difference between the option price and the fair market value of the stock at exercise in a disposition of stock acquired from a qualified stock option[2] and disposed of in a disqualifying disposition was taxable as compensation for services having a source where the taxpayer performed services for the corporation. Although the stock was sold in a disqualifying disposition, the Court stated in a footnote that the same result would apply for sourcing of the gain from qualifying dispositions. Only the remainder of the gain, the difference between the fair market value at exercise and the selling price of the stock, would be sourced according to the rule prescribed for income from intangibles, i.e., the taxpayer's residence at the time of sale. The *Michaelsen* Court relied on *Commissioner v. LoBue* (1956) 351 U.S. 243 ("*LoBue*") to support its decision. The *Michaelsen*

[1] With respect to gain from the qualifying disposition of stock received from the exercise of an incentive stock option, New York grants capital gain treatment. For determining income from New York sources of a nonresident of New York, it sources a portion of the gain based upon where the nonresident performed the services.

[2] A qualified stock option is the forerunner of and functionally equivalent to an ISO.

Court stated that the decision was in accord with N. Y. Tax Law 632, because the income was compensation attributable to the taxpayer's "business, trade or profession carried on in this state." (*Michaelsen* at p. 584.)

New York issued a Technical Service Bureau Memo consistent with the sourcing principles expressed in *Michaelsen* applying the result to both qualifying and disqualifying dispositions. (TSB-M-95(3)I, Nov. 21, 1995.)

Both Connecticut and Idaho have followed *Michaelsen* administratively and the *Michaelsen* decision has been cited with approval in non-ISO cases in Michigan and New Jersey. (Regs., Conn. St. Agencies, Sec 12-711(b)-16 (1994); Idaho Admin. Bulletin 99-10 (1999) 99-10 IAB 493; *Albert J. Molter v. Department of Treasury* (1993) 443 Mich. 537; *Malcolm* W. *McDonald v. Director of Taxation* (1989) 10 N.J. Tax. 556.)

Law

It is well-settled that the difference between the option price of a nonstatutory stock option[3] and its fair market value at exercise is taxable at the date of exercise as wages having a source where the services were performed if the option was transferred in connection with the performance of services and if that option did not have a readily ascertainable fair market value at the time of grant.[4] (Treasury Regulation section 1.83-7; *Appeal of Charles W. and Mary D. Perelle*, 58-SBE-057, December 17, 1958.) For example, if an employee were granted a nonstatutory option, the option did not have a readily ascertainable fair market value and all services performed for the employer were in California, the difference between the option price and the fair market value of the underlying stock at exercise would be income having a source in California because it would be characterized as compensation for services rendered in California.

Incentive Stock Options (ISOs) are treated differently.[5] If the employee holds stock from the exercise of an ISO for the two required holding periods (two years from the date of grant of the option and one year from the date of exercise of the option), no income will result at exercise. (Revenue and Taxation Code section 17501 conforming to Internal Revenue Code sections 422(a) and 421(a)). The basis of the stock is the option price. The difference between the option price and the eventual selling price of the stock is taxable as a capital gain. (Revenue and Taxation Code section 18031 incorporating Internal Revenue Code section 1001(a).)[6]

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[3] A nonstatutory option is one that does not meet the statutory requirements of incentive stock options or other similar provisions.

[4] If the option is granted to an employee in connection with the performance of services and the option has a readily ascertainable fair market value at the time of grant, then it is taken into income by the employee at the time of grant. (Treasury Regulation section 1.83-7(a).)

[5] ISOs by definition are not transferable and hence do not have a readily ascertainable fair market value at the time of grant. (Internal Revenue Code § 422(b)(5).)

[6] The difference between the fair market value at exercise and the amount paid for the option is treated as compensation for services for purposes of the Alternative Minimum Tax ("AMT"). This occurs because the

If either of the required holding periods is not met, the transaction does not receive ISO treatment and the spread at exercise (i.e., the difference between the fair market value at exercise and the option price) is taxable as wages in the year the stock is sold and a corresponding corporate deduction is allowed. (Revenue and Taxation Code section 17501 conforming to Internal Revenue Code sections 421(b); *Sun Microsystems Inc. and Consolidated Subsidiaries v. Commissioner* (1995) 69 TCM 1884.) Only the increase in value after exercise, if any, is taxable as a capital gain. (Revenue and Taxation Code section 18031 incorporating Internal Revenue Code section 1001(a).)

Income in the nature of compensation for services has a source where the services are performed that give rise to the income. (*Appeal of Janice Rule*, 76-SBE-099, October 6, 1976; Cal. Code Regs., tit. 18, section 17951-5.) This sourcing principle applies to all income characterized as wages, including the difference between the option price and the fair market value of stock at exercise in the case of a nonstatutory option or a disqualifying disposition of stock acquired from an ISO. (*Appeal of Charles W. and Mary D. Perelle, supra,* 58-SBE-057.)[7] There is no authority directly addressing the source of income in the case of a qualifying disposition of stock acquired from an ISO. Income from the sale of stock, generally, has a source in the taxpayer's state of residence. (Revenue and Taxation Code section 17952; *Miller v. McColgan* (1941) 17 Cal. 2d 432.)

Analysis and Conclusion

Neither California nor the federal government characterizes the portion of the gain representing the spread at exercise in a qualifying disposition as compensation for services. Such income is presently not subject to income tax withholding, FICA tax or FUTA tax. (Internal Revenue Service, Notice 2001-14, February 5, 2001.) There is a distinction between stock options which meet the requirements of Internal Revenue Code section 422 and those which do not. (See e.g., *Sun Microsystems, supra*, 69 TCM 1884*; Apple Computer, Inc. v. Commissioner* (1992) 98 T.C. 232.) In fact, Treasury Regulation section 1.83-7(a), which characterizes the spread at exercise of a nonstatutory option as compensation, expressly does not apply to qualifying dispositions. Neither does a qualifying disposition generate a corporate deduction for compensation paid to employees. (Revenue and Taxation Code section 17501 incorporating Internal Revenue Code section 421(a)(2).) Rather, the spread at exercise is characterized as a capital gain as part of the gain from the sale of stock. Accordingly it should not be characterized as compensation for services for sourcing purposes. The *LoBue* decision treats this bargain element as compensation for services for federal purposes; however, that case dealt with nonstatutory options granted and exercised prior to the enactment of statutory options. It is clear that in enacting statutory stock option provisions, Congress intended to change the *LoBue*

ISO provisions do not apply for AMT purposes and the income is treated as though derived from a nonstatutory stock option. (Internal Revenue Code section 56(b)(3).)

[7] This represents the position we have taken in recent appeals before the State Board of Equalization. Our position was sustained in the *Appeal of Gene L. Clothier* decided by the Board of Equalization on June 30, 2000 (Appellant's Petition on Rehearing as denied on November 2, 2000), an unpublished decision not citable as authority.

result. California has conformed to the federal law and the treatment of qualifying dispositions as capital gain with no portion taxed as wages.

Because California includes the spread at exercise in the measure of the capital gain on a qualifying disposition and characterizes the gain as income from the sale of stock, the entire amount of the gain is sourced according to the residence of the taxpayer on the date of the sale, in accordance with the sourcing rule that applies to income from intangibles.

Tax Counsel