Executives Beware: States May Look To Equity Compensation for Revenue

by Cara Griffith

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Many public corporations and even some closely held businesses use equity-based compensation awards to attract, motivate, and reward employees. Equity-based compensation includes nonqualified and incentive stock options (ISOs), restricted stock units (RSUs), stock appreciation rights (SARs), performance shares and units, and dividend equivalent units. Equity compensation allows high-performing employees to share in the profits of the business. That compensation also encourages long-term relationships with the business because many equity compensation plans must vest before the employee receives income from the award. Unvested portions are forfeited if the employee does not meet required performance goals or if employment is terminated before the vesting period is up.

Many employers also do not have sufficient procedures to properly comply with the patchwork (or absence) of state rules regarding equity compensation.

Although an equity-based compensation plan may seem like a good incentive to employees because it creates an ownership culture at the corporation, the plan does not come without any burdens. In addition to the administrative burdens of properly structuring an equity compensation plan, there are federal and state tax burdens for both the corporation and the employee. Because of the vesting requirements for most types of equity compensation, awards will be based on an employee's service over several years. During those years, employees may move or be transferred from one state to another. Employees may also regularly work in more than one location. Those moves create compliance burdens for the employer, which is required to withhold state individual income tax for both the state in which the employee is a resident and any other states to which income may be sourced. To properly do so, the employer must know the residency status of its employees as well as where its employees worked every day during the compensable period each equity compensation award covers. Many employers lack internal procedures to do so. Many employers also do not have sufficient procedures to properly comply with the patchwork (or absence) of state rules regarding equity compensation.

This article explores equity-based compensation awards as well as the federal and state tax treatment of those awards. The article then looks at the state tax issues that face employers that have, or are considering using, equity-based awards as a form of compensation for employees. These issues include withholding nonresident state income taxes, tracking employees' service locations over the course of several years, and determining the compensable period. Equity-based compensation plans are valuable motivation and retention tools for employers, but can be cumbersome and costly if the tax consequences are not properly addressed.

Equity Compensation

Equity-based compensation awards come in a variety of forms and may be offered not only by public corporations but also by closely held corporations and limited liability companies.[1] In general, an equity-based award assumes that a corporation issues shares of stock to an employee as a means of compensating that employee. The premise is that equity-based compensation will encourage employees to assume more ownership of the company (and therefore, their work) and will align employees' interests with those of the company. Although an ownership interest in the company is a general theme with equity

[1]Because LLCs may be treated as partnerships for federal tax purposes, the tax implications for them stemming from the issuance of an equity compensation award will be different from the implications for C corporations.

compensation plans, equity-based awards may grant the employee actual ownership in the company, potential ownership in the company, or no ownership interest at all. In that instance, the employee may receive a contractual right to compensation based on an appreciation in the company's value.

This article is focused on the taxation of equity-based compensation and does not specifically address deferred compensation. Since equity compensation awards may include some level of deferral because of vesting requirements, the terms "equity compensation" and "deferred compensation" are sometimes used interchangeably. However, some forms of equity-based compensation plans do not result in deferral of income, and equity-based compensation may not fall within the definition of a qualified or nonqualified deferred compensation (NQDC) plan. As noted by Robert Spielman, a partner with Marcum LLP, "equity compensation is in a sense deferred compensation," although with equity compensation the employee would have some participation in the upside of the award. That is, the employee would benefit when the company does well and the value of its stock increases. By contrast, with most deferred compensation plans, the value of an employee's award would not be tied to the company's performance.

Generally, a qualified deferred compensation plan is one that meets the requirements of IRC section 401(a). Those include that the plan provide minimum coverage to all employees on a nondiscriminatory basis.[2] There are also limitations on the amount of benefits employers can provide.[3] If a plan meets the requirements, preferential federal tax treatment is afforded, which permits the employer to a tax deduction for amounts contributed to the plan. For employees, contributions in the plan grow on a tax-deferred basis. Employees are not taxed on contributions until they are distributed. NQDC plans are those that do not meet the requirements of IRC section 401(a).

Types of Equity Compensation

Historically, perhaps the most common form of equity compensation is a stock option, which is an agreement by a corporation that gives an employee the right (though not the obligation) to buy or sell a specific number of shares of stock at an agreed-on price within a defined period of time. If the option is not exercised within the defined period, it will expire. In addition to an expiration date before which the stock option must be exercised, there may also be a vesting period before which the stock option may not be exercised. Although stock options may have a vesting requirement, the grant or sale of stock is generally not, by itself, considered deferred compensation.

Stock options may be classified for federal income tax purposes as either nonqualified stock options (NQSOs) or ISOs. NQSOs may be awarded to anyone who provides services to a company, not only employees. NQSOs do not, however, have the same benefits as ISOs. Because the grant of an NQSO is a form of compensation, the employee or the person providing services to the company must report ordinary income when the option is exercised. The amount of income that must be reported is any excess of the fair market value of the shares received over the option price.

ISOs are available only to employees and must meet the requirements of IRC section 422. One advantage of an ISO over an NQSO is that no income tax is reported on gain when the ISO is exercised. Gain is calculated on the difference of the exercise price and the FMV of the shares when they were issued.[4] Also, if specific requirements are met, gain from the stock is taxed as long-term capital gain.[5] ISOs and NQSOs with an exercise price that is equal to or exceeds the FMV of the stock at the time of grant are generally not subject to deferred compensation rules.

Another form of equity compensation is restricted stock, which is a grant of actual shares of stock to an employee, subject to a vesting requirement. Unlike with a stock option, when restricted stock is granted, the employee becomes the owner of the shares and is entitled to the benefits of ownership, including the right to vote and receive dividends. The shares may not be transferred, however, until the vesting conditions have been met. For federal income tax purposes, grants of restricted stock with a vesting condition are not taxed at the time of the grant unless the employee makes an affirmative election under IRC section 83(b) to be subject to tax at that time. Unless the election is made, the employee will be taxed when the shares vest.

Among the other types of equity compensation is an RSU, which is a promise for the transfer of shares of stock if vesting conditions are met. In essence, an RSU is a grant whose value is determined by shares of stock, but no stock is issued at the time of the grant. Once the vesting condition for an RSU has been met, the company will distribute the shares (or the cash equivalent) to the employee. An RSU is not subject to

[2]IRC section 401(a)(5).

[3]IRC section 401(a)(5)(B) permits differences in the amount of contributions made to various employees, but only to the extent that the differences "bear a uniform relationship to the compensation" of those employees.

[4]Note that the option holder may have to pay alternative minimum tax instead.

[5]The shares must be held for one year from the date the option is exercised and two years from the date the option is granted.

federal income tax until the shares of stock are distributed. An RSU may be considered deferred compensation if the employee has the right to elect to defer payout of the stock to a future tax year.

There are also SARs and phantom stock, which are cash bonus plans that may pay out benefits in the form of shares. SARs provide an employee with a right to receive a cash bonus (though it may be settled in stock) that is equal to the appreciation in a specific number of shares of stock during a specific period. There is generally a vesting requirement for SARs, which are considered deferred compensation unless specific requirements are met. Phantom stock provides an employee with a cash or stock bonus that is based on the value of a specific number of shares. Vesting is customary with phantom stock because the bonus will be paid out at the end of a specified period.

Finally, though this is not an exhaustive list of the types of equity-based awards available, there are employee stock purchase plans (ESPP). An ESPP is a stock option plan that allows employees to purchase company stock at a discount. ESPPs receive favorable tax treatment, but for that reason, there are specific requirements for how an ESPP is structured. With a typical plan, employees are permitted to make payroll contributions that are later used to exercise a specific number of options at the end of a set period. ESPPs that qualify under IRC section 423 are not subject to deferred compensation rules.

Federal Taxation of Equity Compensation

In general, IRC section 83 provides that any property received in exchange for services being provided is includable in income when the property is transferable or no longer subject to a substantial risk of forfeiture. Recognition of gain or loss on an equity compensation award is often deferred for tax purposes until there is a realization event (that is, the stock option being exercised). Simply satisfying an award's vesting requirement, however, may not be a trigger for tax purposes, said Scott Rollin, president and founder of Management Compensation Resources LLC. There can still be a substantial risk of forfeiture even after an equity compensation award has vested, Rollin said. For example, if an ISO has vested, there is still a chance that the company of the underlying stock will go bankrupt, which would render the ISO valueless. For that reason, an award must be both vested and payable before federal income tax consequences are triggered, Rollins said.

That said, there are numerous factors that can affect the federal taxation of equity compensation — the largest factor being the type of equity compensation involved. For example, the tax treatment of a stock option hinges on whether the option qualifies as an ISO. If some requirements for an ISO are met, including that the vesting period has been met, the employee holding the ISO will not be taxed on any gain until the stock received on exercise of the ISO is disposed of.[6] At that point, any gain will be taxed as long-term capital gain rather than ordinary income. The employer is not entitled to any deductions at the time of grant or exercise of an ISO or on the employee's sale of the underlying stock. However, the employer may claim a deduction on a disqualifying disposition of an ISO.

An employee who receives an NQSO, which is more commonly issued by corporations than an ISO, recognizes ordinary income based on the spread when the option is exercised. The spread is the difference between the FMV of the stock at the time of exercise and the strike price, or the price stated in the option contract at which the contract may be exercised. The employer is entitled to a deduction equal to the income realized by the employee. The corporation is liable for income and employment withholding at the same time and, in order to receive the deduction, must comply with the Form W-2 (Wage and Tax Statement) and Form 1099 (Miscellaneous Income) reporting requirements. Often the corporation and employee will enter into an option agreement to specify how the withholding should be handled. That agreement may require the employee to remit cash or shares equal to the withholding amount or provide that the corporation will gross up the compensation to allow the employee to pay the tax liabilities. The tax treatment of SARs is similar to that of NQSOs.

For restricted stock, unless a section 83(b) election is made, the recipient of restricted stock will recognize ordinary income that equals the FMV of the stock when it vests. The employer is permitted to take a deduction in the same amount at the same time. If the section 83(b) election is made, the employee will recognize ordinary income in the amount of the FMV of the stock at the date of grant. The employer receives a matching deduction then.

Determining the federal tax treatment of equity compensation is far from a perfect science. There are instances in which the grant of stocks may be consistent with the taxation of cash, such as when a section 83(b) election is made for the receipt of restricted stock. Arguably, there is little tax advantage for employees in receiving equity compensation, at least from a federal tax standpoint. However,

[6]IRC section 422(a)(1) requires that an employee hold the underlying stock of an ISO for the later of two years after the grant of the ISO or one year after the exercise of the ISO. Failure to satisfy the holding period results in a disqualifying disposition and the employee must report any gain recognized at the time of exercise as ordinary income for the year of disposition.

employers may be able to structure equity compensation awards to their benefit. For example, corporations may be able to exempt from taxation the returns on NQSOs because they are not subject to tax on investments in their own equity. A complete discussion of the federal income tax consequences of equity compensation is well beyond the scope of this article, but a discussion of the state taxation of equity compensation would not be complete without at least a federal tax backdrop.

State Taxation of Equity Compensation

For state individual income tax purposes, the specific tax treatment of an equity compensation award generally follows the federal treatment of the same type of equity award. That is largely because most states use federal adjusted gross income as the starting point for calculating their state income tax liability. Of course, that is not a hard and fast rule because several states do not follow the federal tax treatment of equity compensation. For example, Hawaii and Rhode Island may not tax income recognized from exercising stock options if those options were issued by qualifying corporations.[7] In both states, qualifying corporations are those engaged in specific high-technology activities.

Numerous states also use the federal definition of wages for purposes of state income tax withholding and follow the federal income tax withholding schedule.[8] Because of that conformity, most states require income tax withholding when the equity compensation received by a taxpayer is properly included in the taxpayer's federal AGI. In general, that means that income from equity-based compensation will be included in a taxpayer's federal AGI when the income from the equity award is received by the employee (for example, when the stock option is exercised) or when the award is no longer subject to substantial risk of forfeiture (for example, when an award is vested and payable).[9]

> ***Several states do not follow the federal tax treatment of equity compensation.***

Income from an equity compensation award is considered wage income and will be reported on a taxpayer's Form W-2. The state in which a taxpayer is a resident when the equity compensation is properly included in the taxpayer's federal AGI will be the state that first sees the income on the taxpayer's W-2 and therefore will subject the taxpayer to income tax on the entire amount of income from the equity award (if the state imposes an individual income tax). Unquestionably, states may tax residents on all of their income. Brian Browdy, a principal with Ryan LLC, said the due process clause of the U.S. Constitution and state constitutions provides states with the authority to tax residents on 100 percent of their income regardless of its source. That means, for example, that an employee that receives a stock option will be subject to tax in his resident state on income received when the option is exercised regardless of whether the option was awarded when the individual was a resident in another state. An individual is generally considered a resident if he is domiciled in the state or maintains a permanent place of abode within the state and spends a specific number of days in the state (for example, more than 183 days).

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Residency is not a given. States can challenge an individual's residency status. In an equity compensation context, residency challenges may occur when an individual who received an award while a resident of a high-tax state moves to a low- or no-tax state before a realization event regarding the equity award. Spielman said that in that situation a state may want to examine whether the individual has actually given up residency in the high-tax state and established residency in the lower-tax state. He also cautioned that state residency rules can be illogical, with new questions raised on the individual income tax return. John McGowan, a partner with Baker & Hostetler LLP, said that in the context of equity compensation, states do not frequently encounter the issue in which executive receives the equity compensation only after having moved out of state because most executives receive those awards while they are still working. "The amount of slippage isn't that great" in that area, said McGowan.

Nonresident Income Taxation

Whether a state will subject the income from an equity compensation award of a nonresident to tax is typically a more complex question. States can subject nonresident individuals to state income tax on income they receive from sources in the state. However,

[7]*See* Hawaii Rev. Stat. sections 235-7.3, 235-9.5; R.I. Gen. Laws sections 44-39.3-1.

[8]IRC section 3401(a) defines wages as remuneration for services performed by an employee for an employer, including the cash value of all remuneration paid in any medium other than cash.

[9]*See* IRC section 83(a).

before delving too far into the state income taxation of nonresidents who received equity awards while working or residing in the state, it should be noted that a federal law prohibits state income taxation of some pension income of nonresidents. That is, 4 U.S.C. 114 (P.L. 104-95) prohibits states from taxing some pension income of nonresidents received after December 31, 1995. That law was largely a response to actions by California and New York (and other states, though to a lesser extent) to impose tax on the pension income of former residents that had moved to another (typically no-tax) state.[10]

Although many types of pension plans are covered, the law limits the coverage of NQDC plans to those specified in IRC section 3121(v) and does not cover any payments from other types of equity-based compensation plans. The law does not prohibit states from imposing tax on income received by nonresidents from stock options, SARs, and restricted stock. With that in mind, practitioners are in agreement that for many types of non-equity deferred compensation and for equity-based compensation, states have the right to tax income from sources within the state, regardless of where the taxpayer is currently domiciled.

A few states are beginning to address how the income of a nonresident from an equity-based award will be taxed, though that is a relatively new concept for many states. For example, Minnesota issued Revenue Notice 01-10, which clarified a law change that passed in 2008 regarding how some types of nonresident wage income are assigned to the state. The notice provides that for nonresidents "income from wages is assigned to Minnesota to the extent that the work of the employee is performed in Minnesota." The notice provides additional information for specific types of equity-based awards. For example, income from some stock options will be assigned to Minnesota based on the ratio of days the individual worked in Minnesota during the allocation period to the total number of days worked for the employer during the allocation period. The allocation period is the time between when the equity-based award is granted and when it ends, which is the earlier of when the award is substantially vested or when it is sold.

When a state asserts tax against the income of a nonresident, the nonresident may be able to claim a credit in the individual's state of residence, which would alleviate double taxation of the income, Browdy said. States generally do not automatically provide those credits. Taxpayers must file the appropriate form to request any available credits. States also generally limit the amount of the credit to the lesser of the tax imposed on the income by either state. That has the effect of taxing the income at the higher of the two states' rates. Taxpayers should also be aware of reciprocal agreements a state may have with other states. Those agreements prevent double taxation by providing, for example, that an employee in Minnesota who resides in North Dakota is only taxed by North Dakota as a result of her income earned in Minnesota.

Withholding

In addition to generally following the federal tax treatment of the varying types of equity-based awards, most states also follow the federal income tax withholding schedules regarding equity-based awards. That is because most states require employers to withhold on compensation that is considered wages for purposes of federal income tax withholding. Employers are generally required to register for state income tax withholding if they have an office in the state or are conducting business in the state.[11] Failure to satisfy their withholding requirements can subject employers to interest and penalties. Note that in some states — for example, New York and Georgia — withholding may not be required for some taxpayers if the level of equity compensation received is below a specific threshold.

Withholding is generally required when a taxable event occurs regarding the equity award. As noted above, a taxable event occurs when an equity award is fully vested and payable or, for example, a stock option is exercised. The employee's state of residence when the taxable event occurs will tax any compensation received and the employer would be required to withhold income tax in that state, but if the income from the equity award is attributable to services performed in another state or in multiple states, the employer may also be required to withhold income tax in those states.

That scenario can be particularly difficult for employers because managing nonresident withholding can be administratively burdensome. Large organizations and those with employees who frequently travel for work purposes have difficulty tracking the number of days each employee spent in various jurisdictions. Employers also have to keep track of law changes in each state in which they are required to withhold for any employee.

Once employers have determined that they are required to withhold state income taxes on income

[10]The law covered all payments from IRC section 401(a) qualified plans, section 408(k) simplified employee pensions, section 403(a) annuity plans, section 403(b) annuity contracts, section 408 IRAs, section 457(a) eligible deferred compensation plans, section 414(d) governmental plans, military retired or retainer pay plans, and section 501(c)(18) employee contribution trusts.

[11]Determining whether an employer is conducting business in a state can be a difficult and nuanced determination that is beyond the scope of this article.

from equity-based awards, the next step is determining how much to withhold. That calculation can be challenging because different states do not necessarily use the same formula for determining the amount of tax due on an equity compensation award. For example, New York may determine the tax liability of a nonresident based on the change in value between the date the equity award was granted and when it is fully vested.[12] In contrast, Virginia may determine tax liability on the difference between the value when the equity award was granted and when it was actually exercised.[13] Valuing an equity compensation award itself can be challenging, particularly when dealing with non-public companies. McGowan said that although most state tax commissioners know the value of every public company in the state, non-public companies can discount their value for a variety of reasons and move equity around to be more tax efficient.

> ***Different states do not necessarily use the same formula for determining the amount of tax due on an equity compensation award.***

Also, if the employee worked in more than one state or lived in one state and worked in another, it can be difficult to determine how much of the equity award is attributable to each state. Because of that difficulty, many employers will withhold based on the allocation percentage for the year in which the equity-based compensation is included in the taxpayer's income. But if the equity award was compensation for an employee's service in multiple states, the employer should allocate the income based on the ratio of days worked in a particular state with the total number of days worked during the compensable period. Equity awards are generally compensation for service over a number of years. That is, of course, easier said that done. Some states will look at the number of days that the employee worked in the state versus the total workdays for the specific time period. However, the longer the employee has been with the company and the longer an equity award is held before a taxing event, the more difficult it is to determine where that employee was every day. States provide limited guidance on equity-based compensation, so employers are largely left to figure out withholding by trial and error.

Of the states that do have some written guidance on the issue, California, for example, provides that to determine the compensable period for purposes of allocating stock option income, the employer should assume that the period begins on the grant date and ends on the exercise date.[14] By contrast, Connecticut provides that the compensable period begins on the first day of the tax year in which the grant is awarded and ends on the last tax of the tax year in which the taxable event occurs (exercise, vesting, and so on).[15] That means that an employee may have been awarded restricted stock on July 1, 2008. If the award vested on January 1, 2012, the compensable period runs from January 1, 2008, through December 31, 2012.

State tax codes provide little clarity for employers on their withholding obligations. Also, the Mobile Workforce State Income Tax Simplification Act of 2011, pending in the U.S. Congress, does not provide guidance on how to handle either equity or non-equity deferred compensation. For several years, New York has been the exception to the rule. In 2005 the state issued Withholding Tax Field Audit Guidelines and updated the Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax.[16] The guidelines instruct employers to withhold on 100 percent of an employee's deferred compensation unless the employee provides the employer with the proper allocation percentage or the employer has adequate records to determine the proper allocation percentage. Although that guidance does provide some detail on an employer's withholding requirements, it does not relieve the employer from potentially burdensome record-keeping requirements.

Although states have not historically been aggressive in going after nonresident individuals with equity-based compensation awards, that may change. The recession and tight budgets have forced states to be creative. Although practitioners are not in agreement about states' level of enforcement in that area, it is one that bears watching. As states have become more desperate for revenue, some are questioning whether to follow federal AGI for purposes of calculating an individual's state taxable income, McGowan said. They are also becoming more open-minded when thinking about how income is defined and are more focused on exactly how income is being reported on a taxpayer's W-2, McGowan noted. All that leads to the conclusion that employers and employees should be on the lookout for more focus by states on equity compensation. ✰

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[12] *See, e.g., Matter of Michaelsen v. New York State Tax Comm'n*, 67 N.Y. 2d 579 (1986).

[13] *See, e.g.,* Virginia Dep't of Taxation, P.D. 99-77, in which the commissioner ruled that the appreciation in the value of stock from the date of grant to the date of exercise is compensation from Virginia sources for services performed in the state.

[14] Cal. Franchise Tax Board Publication 1004 (Mar. 2005).

[15] Conn. Gen. Stat. section 12-705(a).

[16] New York State Department of Taxation and Finance, Publication NYS-50, *Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax* (May 26, 2006).