ASSESSMENT OF PUBLIC COMMENT

DEPARTMENT OF TAXATION AND FINANCE

Written comments were received from the public regarding proposal TAF-43-06-0007 from Charles Nanavaty, CPA, of Nanavaty, Nanavaty and Davenport, LLP, Richard S. Schwarz, Tax Counsel and Director of Government & Fiscal Affairs for The Business Council of New York State, Inc. ("Business Council") and Eric Taussig, Esq. of Moultonborough, New Hampshire.

Mr. Nanavaty agreed that the grant-to-vest allocation method in the proposed regulations (for statutory stock options, nonstatutory stock options without a readily ascertainable fair market value at the time of grant and stock appreciation rights) was reasonable, but also wanted compensation from options or rights to be realized at vesting. He thought that after an option becomes vested, it changed from compensation to investment and in deciding to hold, sell or convert the option, the grantee was acting more as an investor than as an employee.

Section 631 of the Tax Law provides that New York source income of a nonresident individual is the sum of the net amount of items of income, gain, loss and deduction entering into federal adjusted gross income which are derived from or connected with New York sources plus certain modifications. New York State conforms to federal treatment of items of income. As the proposed regulations note, in section 132.24(a)), income from stock options, stock appreciation rights, and restricted stock is realized when the income is realized for federal income tax purposes and is reportable to New York State in the taxable year that the income is included in the individual's federal adjusted gross income. The compensation income from statutory stock options, nonstatutory stock options without a readily ascertainable fair market value at the time of grant and stock appreciation rights that is being allocated is realized at the date of exercise, not at vesting (see, Matter of Michaelsen v. New York State Tax Commission, 67 N.Y.2d 579).

No changes were made to the proposal as a result of Mr. Nanavaty's comments.

Mr. Schwarz submitted comments on behalf of the Business Council. He stated that the comments reflected both current law and the opinion of the Council's Committee on Taxation members. The Business Council advocates for allocation based on the year of exercise, resulting from the recent Tax Appeals Tribunal decision in the Matter of Stuckless, as opposed to the grant-to-vest methodology in the regulation, citing the following reasons for its position:

1. The year-of-exercise rule in Stuckless is a valid, reasonable, and appropriate measure for sourcing stock option income.
2. Stock option income is earned in the year that the employee decides to exercise the options, which is commonly based solely on the market increase in the stock value.
3. The year-of-exercise method would impose less record keeping requirements for both employees and employers than either the grant-to-vest or grant-to-exercise methods.
4. Although the Internal Revenue Code has a grant-to-vest provision for U.S./foreign sourcing of income, it does not have such provisions for taxpayers with only U.S. source income from stock options. If federal conformity is the main goal of the Department, then employers should be permitted to use any reasonable method including looking at only the year of exercise for administering their stock option programs, provided they do so on a consistent basis.
5. The standard most contemporary in transpiration of time (that is, the year of exercise) with realization of income would enhance compliance, accuracy, efficiency, and auditability.
6. To prevent confusion, the proposed regulation should contain expanded definitions of the types of deferred compensation covered by the sourcing rule. Companies have many different types of deferred compensation programs which are similar to stock options and stock appreciation

rights, such a restricted stock units and phantom stock, which should be covered by these rules.

The Department gives the following responses to the Business Council comments:

1. The Department views the grant-to-vest method as a more appropriate method for allocating compensation income than the year of exercise, since the work days in the year of exercise do not necessarily correlate to the individual's performance of services with respect to the option or right. The time of exercise, once vested, is at the individual's discretion; and as pointed out in the comments, it is usually market driven. The time period from grant to vest is service-related, as at the time of vesting the individual has performed all service-related conditions required by the grantor to exercise the option or right. It should be noted that, in the process of developing the regulation, we received input from taxpayer representatives who recommended the grant-to-vest method.
2. Although income is realized when the option or right is exercised, an individual has performed all service-related conditions for the right to exercise an option or right at the time of vesting. It is appropriate to look at the period ending with vesting to determine the allocation of the compensation for the services.
3. The year of exercise may be a simpler method of allocation, by virtue of it being a single-year allocation, but as stated above, it is not tied to the time period in which an individual performs the services required by the grantor before the option or right can be exercised. The Department does not view record keeping for the time from grant to vest as a hardship. The allocation method in the rule contains a workday fraction obtained by including days worked in New York State and days worked within and without the state. This is not a new reporting or paperwork requirement, as to compute wage income derived from New York State sources,

nonresident employees and officers are already required to keep track of their working days both within and without New York State (20NYCRR132.18). Additionally, the time period necessary to keep workday records for calculation of New York source income from compensation income attributable to stock options, restricted stock and stock appreciation rights is less than under the method outlined in a 1995 technical memorandum issued by the Department (TSB-M-95(3)I). The effect on employers is limited to a possible change in methodology for calculating withholding amounts for some employees and officers to meet the requirement that the amount withheld is substantially equivalent to the amount of tax due.

4. The Internal Revenue Code sourcing rule for nonresident aliens was viewed by the Department as a reasonable and fair apportionment for stock option income, but federal conformity was not the Department's main goal. The proposed regulation does not entirely duplicate the IRS sourcing rule, which provides a great deal of flexibility dependent upon an individual's facts and circumstances. The proposed regulation provides a specific rule which applies to everyone. In situations where the proposed rule may produce an unfair result, the Department's regulations already provide individuals with an option to use an alternate allocation that would more fairly apportion their New York source income (section 132.25).

5. In deciding to use a grant-to-vest allocation for statutory stock options, nonstatutory stock options without a readily ascertainable fair market value at the time of grant and stock appreciation rights, the Department's main consideration was fair allocation. We do not believe that compliance, accuracy, efficiency, or auditability are compromised by this rule.

6. The regulation was written to comply with a statutory directive which called for a regulation specifically for stock options, stock appreciation rights and restrictive stock. The Department

would welcome input as to whether additional guidance should be given on the other types of deferred compensation plans.

For the reasons stated above, no changes were made to the rule based on the Business Council comments.

Like the Business Council, Mr. Taussig thinks that the year-of exercise method in Stuckless is the proper rule. He states that the proposed regulation conflicts with Michaelsen and Stuckless and the Department went beyond the legislative authorization in section 631(g) of the Tax Law and created an unconstitutional taxing scheme. He also contends that the Department's policy is to tax an employee who at one time was a New York employee even though there is no connection between the employee/option holder's income and New York after the employee leaves New York employment.

In response to the comments that the year-of-exercise rule in Stuckless is the proper rule, we refer back to responses 1, 2 and 3 above, which demonstrate why the grant-to-vest method is a more appropriate method for allocation. Also, in a situation where an employee leaves New York employment but performed services in New York for the grantor during the grant-to-vest period, there is a connection between the compensation and New York. It is during this period that the individual performs all the services required by the grantor to exercise the option or right. The Stuckless decision dealt with the previous regulations of the Department; this proposal is new and there is specific legislative authority for the regulations in Chapter 62 of the Laws of 2006.

Regarding Mr. Taussig's claim that the Department is going beyond section 631(g), it is important to note the legislation itself. This section (along with section 638(c)) was added by such chapter and provides that the allocation of compensation income from stock options, stock appreciation rights and restricted stock should be prescribed by regulations of the Commissioner. Paragraph 3 of section N of such chapter provides that the regulations may apply to taxable years beginning on or after January 1, 2006 and may be controlling notwithstanding any Tax Appeals Tribunal decision to the contrary. The proposed regulation does not go beyond the legislation because it is a reasonable method for allocation, one that was recommended by taxpayer representatives and is similar to the Internal Revenue Code sourcing rule for nonresident aliens.

For the reasons stated above, no changes were made to the rule based on Mr. Taussig's comments.

We also received an informal phone comment from a taxpayer which indicated that it was not clear that the New York workday fraction pertained only to services performed for the grantor. Although this comment was not a written comment that is required to be addressed under SAPA section 202.5, it is noted that we revised the definition for the New York workday fraction in section 132.24(c)(2) to clarify that the workday fraction is based solely on the individual's services performed for the grantor of the stock option, stock appreciation right or restricted stock.