

3rd Annual CEP Symposium 

## Certified Equity Professional Institute

### Home Sweet Home?!?

Managing Mobile Employees in the US When They Can't Seem to Settle Down

Bob Peterson and Carol Rutlen 

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### Agenda

- Impact of domestic moves
- What do you withhold
- How do you make this happen

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### General Rules

- Most states follow federal rules on taxation of stock options
- Earned vs. recognized
  - Earned over time
  - Recognized at a specific point in time
- Amount taxable may differ by state
- Dependent on residency status
- State tax credit may be available

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### Definition of Residency

- Varies state by state
- Possible to be resident of more than one state – but unlikely
- Most states tax 100% of income of residents
- Most states tax income of non-resident earned in the state
  - Equity compensation earned over time
  - Allocation of income may be required

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### California Residency Rules

- Resident
  - Individual present in California for other than temporary or transitory purpose
  - Individual domiciled in California
- Non-resident: not a California resident
- Presumption that every individual who spends 9 months or more of the taxable year in California is a resident
- Residents taxed on worldwide income
- Non-residents taxed on income earned in California

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### Example 1 – Move to California

1/1/02 John is a resident of Texas

- Granted an option to purchase 10 shares of stock for \$1 per share
- Option vests in 3 years


1/1/05 Option vests

7/1/05 John moves to California and becomes California resident

1/1/06 John exercises his option when FMV = \$5 per share

*What is taxable in California?*

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**California – Non Qualified Options**

- **Move to California**
  - Granted while a nonresident, exercised while a resident
  - Taxed on worldwide income
  - 100% of bargain element taxed
- **Move out of California**
  - Granted while a resident, exercised while a nonresident
  - Bargain element taxable to the extent earned in California
  - If earned within and outside California, must allocate between states
  - One reasonable method is time
  - Examples use time between date of grant to date of exercise

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**Example 2 – Move out of California**

1/1/02 John is a resident of California

- Granted an option to purchase 10 shares of stock for \$1 per share
- Option vests in 3 years


1/1/05 Option vests

1/1/06 John moves to Texas and becomes Texas resident

1/1/07 John exercises his option when FMV = \$5 per share

*What is taxable in California?*

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**Other State Implications**

- Not all states have rules regarding allocation of stock option income
- Differences in allocation methods may result in double taxation
- **Examples**
  - New York
    - Audit Guidelines – withholding required after 14 days in state
    - Regulations to be drafted governing nonresidents' taxation of options – effective 1/1/06
    - Conflicting judicial precedent for allocation of income
    - North Eastern States Tax Officials Association – reciprocity to other states
  - New Mexico
    - Nonresident taxable to extent income earned in New Mexico
    - Not allocated if < 15 days during the tax year

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**Ways to Mitigate Double Taxation**

- If income is subject to tax in more than one state, a tax credit may be available
- Reciprocal agreements
  - North Eastern States Tax Officials Association
  - Pennsylvania and Maryland
  - Illinois and Iowa

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**Example 3 – State Tax Credit**


- Jane was a resident of State A when the option was granted
- Jane was a resident of State B when the option was exercised
- Both A and B tax 100% of the bargain element

A: $\$1000 \times 5\% = \$50$	B: $\$1000 \times 9\% = \$90$
Pay A \$50	Pay B \$40 ( $\$90 - \$50$ )

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A: $\$1000 \times 9\% = \$90$	B: $\$1000 \times 5\% = \$50$
Pay A \$90	Pay B \$0 ( $\$50 - \$90$ )

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**Required Withholding**

- States usually follow federal rules
- May have to withhold in multiple states
- Does a state tax credit offset a requirement to withhold?
  - Reciprocity
  - AZ: Nonresident may claim exemption from withholding if resident in California, Indiana, Oregon, or Virginia
- Does your payroll system allow withholding in more than one state?

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**Information Needed for Each State**

- How are stock options taxed?
- Is the employee a resident? Where does the employee work?
- Is withholding required?
  - Granted when resident, exercised when nonresident
  - Granted when nonresident, exercised when resident
- Is reporting required?
  - Granted when resident, exercised when nonresident
  - Granted when nonresident, exercised when resident
- Do any of the answers vary depending upon the other state of residency?

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**How Do You Make This Happen**

- Identify employees
  - Self-reporting
  - Risks of service business
- Process
  - Coordinate with payroll
  - Withhold in multiple states vs. turn state withholding on/off
- Policies
  - Employee cash flow
  - Employee compliance
  - Communication with employee

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**Status**

- Companies are starting to focus on these issues
- Targeted by tax authorities
- Leverage system used for international employees

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