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State Tax Considerations for Equity Based Compensation

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The use of equity based compensation (*e.g.*, stock options and restricted stock) is widespread by public corporations as a means to attract and retain employees. Few employers consider the state tax burdens of equity based compensation. Without adequate preparation, these burdens can be a drag on the corporation's economic benefits expected from the equity based compensation.

Providing equity based compensation to employees promotes productivity by expanding the role of employees to include shareholders, who, in theory, will be a more productive, caring and cost-conscious work force. Equity based compensation is also intended to increase employee longevity, reduce turn-over, and heighten loyalty. These effects are consequences of the restrictions placed on selling the shares. For example, restricted stock typically limits an employee's ability to sell before a set period of time expires (*e.g.*, three or four years). Stock options typically require an employee to hold the options for a specified amount of time before the options can be exercised. With both, employees have the incentive to remain with the employer or risk forfeiting the rights to the stock or options.

Equity based compensation typically spans multiple years and creates challenges for employers when it comes to withholding for state personal income tax purposes. Employers are required to allocate an employee's compensation, in general, based upon the amount of time an employee performs services in a particular jurisdiction. However, historically the vast majority of employers have not instituted procedures necessary to track employee movements for equity based compensation withholding purposes. This is compounded by today's current mobile workforce. It is commonplace for highly compensated individuals to travel to numerous states while executing their responsibilities. States are aware of such employee movements and are becoming more aggressive in their enforcement efforts with respect to employer withholding.

Unfortunately, employers are faced with non-uniform or out-dated rules which are not easily workable with respect to the ever-changing forms of equity based compensation. In this article we explore the withholding issues faced by employers today, including the apportionment for corporate income tax, as well as, pending federal legislation and Sarbanes-Oxley Section 404 implications.

When Does An Employer Have Nexus for Withholding Tax Purposes?

An employer is generally required to register for the purpose of withholding in a particular state if the employer either maintains an office or transacts business within that state.[1] For example, in New York the standard is "[e]very employer maintaining an office or transacting business within this state,"[2] and in Massachusetts the standard is "[e]mployers that maintain an office or transact business within Massachusetts."[3] A determination of whether an employer is "maintaining an office" is generally a straightforward analysis of whether the employer has a physical location or place of business in the state. However, in many states there is, unfortunately, little guidance regarding when an employer is considered to be "transacting business" and, therefore, subject to the withholding rules in that state. As a starting point, an employer may seek guidance by looking at the "doing business" standard that is generally applied by the states for the purpose determining corporate income tax nexus. Employers should be aware that the "doing business" standard and the "transacting business" standard are not necessarily interchangeable and the relative breadth of the standards are often unclear. As a result, a state's taxing authority and courts may not be persuaded by the analogy to corporate income taxation nexus.

In addition to the lack of clear and uniform guidance, employers with a mobile workforce face compliance difficulties with state withholding rules. Large organizations, especially those with a traveling sales force, may find it difficult to track where their employees are performing services and the number of days spent by employees in various jurisdictions. Furthermore, if an employer is subject to withholding requirements in several jurisdictions where it does not maintain a physical location or where the services performed by its employees are minimal, the compliance burden of initial registration and subsequent administrative filings may exceed the amount of the withholding for those states. Employers may find it particularly difficult to keep abreast of the law changes in various states where withholding is required. The typical payroll department is not adequately staffed for such tasks. Employers have reason to be concerned that states are becoming more aggressive in enforcing their withholding requirements and have recently brought their concerns to the attention of Congress.

On September 25, 2006, Utah Representative Chris Cannon introduced H.R. 6167 ("Bill"), entitled the "Mobile Workforce State Income Tax Fairness and Simplification Act of 2006." The Bill provides that states and localities may tax only nonresidents who perform employment duties in the jurisdiction for more than 60 days during the tax year.

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[1] In addition, most states permit an employer to voluntarily register for withholding in an employee's state of residence for the convenience of that employee.

[2] N.Y. Tax Law § 671(a); *See also*, N.Y. Comp. Codes R. & Regs. tit. 20, § 171.1(a).

[3] 830 Mass. Code. Regs. 62B.2.1(4).

The Bill explicitly states that wages will not be subject to state and local income tax withholding unless the employee will be liable for taxes in those jurisdictions.

The Bill was referred to the House Judiciary Committee but was not acted upon before the adjournment in December. The Bill may be reintroduced during the 2007 Congressional term.

Employee Tracking Challenges

The difficultly in tracking the movements of employees is a significant impediment to employers instituting proper multistate withholding procedures. First, any procedure for tracking employees will require cooperation from the employees. Unfortunately, employees are generally reluctant to provide such information because doing so may create the need to file personal income tax returns in multiple jurisdictions. In addition, any procedure for tracking will likely be in the form of a costly, custom software application. Finally, if the information is tracked, integration of that information with the payroll function is also likely to be costly and extremely complicated because withholding rules vary greatly from state to state.

Nevertheless, there is certainly a shift in momentum pushing employers to track the whereabouts of their employees. From a state point of view, employers already have the information necessary to track their employees in the form of travel and expense reimbursement records. However, the reality is that integrating expense reimbursement information with payroll functions is easier said than done.

Nexus Issues for Sales, Income & Franchise Tax Purposes

Filing withholding taxes may raise potential exposure for additional types of tax (*e.g.*, sales, income, and franchise). Often a comprehensive review of employee movements will uncover nexus, based upon the physical presence of employees, for other tax types in jurisdictions where returns are currently not being filed. Due to improved computer matching capabilities by states, an employer that registers for withholding tax purposes is likely to receive a nexus inquiry if the employer is not filing sales tax or business activity type tax returns.

Some relief for employers may be found if federal legislation is reintroduced to limit states' abilities to subject out-of-state corporations to business activity taxes. Under the 2006 version of the Business Activity Tax Simplification Act of 2006 ("Act"), H.R. 1956, an employer could have employees in a state for as many as 21 days without being subject to a state's business activity tax.[4] The Act may be reintroduced in the 2007 Congressional term.

Calculating Withholding on Deferred Equity Based Compensation

[4] Under the Act, the term "business activity tax" does not includes sales and use taxes.

With regard to an employer's withholding obligation for equity based compensation (*i.e.*, deferred equity based compensation), state statutes, regulations and administrative pronouncement are generally silent on this issue leaving little, if any, specific guidance for employers. New York is a notable exception. New York provided guidance for withholding on deferred compensation arrangements in the Withholding Tax Field Audit Guidelines ("Guidelines") released on April 5, 2005 and the updated Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax.[5] While the guidance provided in these documents may need to be further updated in light of the changes in New York law regarding the taxation of deferred equity compensation paid to nonresidents,[6] it does at least provide employers with a roadmap for withholding on deferred equity compensation.

The Guidelines instruct employers to withhold on 100% of the deferred compensation unless the employee provides the employer with the proper allocation percentage,[7] the employee provides a proper allocation percentage for non-deferred income and the deferred compensation is less than $1 million, or the employer has adequate records to determine the proper allocation percentage.[8] An employer may not rely on the allocation percentage provided by the employee if it has "actual knowledge or reason to know that is it incorrect or unreliable."[9] If the deferred compensation is less than $1 million, then the employer may withhold based on the employee- provided allocation percentage for the taxable year when the deferred income is recognized by the employee. If the employee does not perform services outside of New York during the taxable year of recognition or if the employee is no longer employed by the employer, then the employer may withhold based on the last allocation percentage provided by the employee. It may be an arduous task for an employer to maintain the records and supervise the proper allocation to insure that the allocation percentage provided by employees may be reasonably relied on.

The recent focus by New York in this area has led many to question why states, unlike New York, are typically lacking in specific guidance for employers to withhold on deferred equity compensation. It is the authors' belief that most states rectify improper sourcing of deferred equity compensation through individual personal income tax audits

[5] 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).

[6] New York has proposed new regulations regarding the taxation of equity compensation for tax years beginning in 2006. The proposed regulations change certain regulations under 20 NYCRR Part 132 as well as create a new section 154.6 and are to apply to taxable years beginning on or after January 1, 2006.

[7] Mechanically, the employee provides the allocation on New York State Form IT-2104.1, *New York State, City of New York, and City of Yonkers Certificate of Nonresidence and Allocation of Withholding Tax*. New York State Department of Taxation and Finance, *Withholding Tax Field Audit Guidelines* (April 5, 2005), p. 22.

[8] "Adequate records include but are not limited to IT-2104.1(s) on file for the entire compensable period." *Id.*

[9] *Id.*

of nonresidents rather than focusing on the source of the compensation, the employer. New York, through its Guidelines, has changed its enforcement focus in this area from nonresident individuals to employers which, in theory, is more efficient than chasing nonresident individuals. We expect other states may follow New York's lead.

In theory, the withholding rules aim to estimate, to the extent practicable, the employees' actual tax liability.[10] In practice, however, without clear guidance, employers often apply the allocation percentage for the taxable year of inclusion to deferred equity compensation instead of applying the more burdensome allocation percentage for the period that may apply for personal income tax purposes.

When an employer compensates a nonresident employee for services performed partly within and partly without the state, the taxable income for that state is a based on the ratio of days worked within compared to the total amount of working days in the taxable year. In the context of deferred equity compensation, which compensates an employee for services performed in more than one taxable year, using the days worked in and out of a state in the taxable year when the income is recognized may not be a good reflection of the amount of compensation that is connected with sources within a state. Many states have not specifically addressed how to allocate deferred equity compensation to sources within the state. Among those states that have provided guidance, the treatments are not uniform. These states generally look at the period beginning on the grant date and ending on the exercise or vesting date and then compute the days worked in and out of the state during that period ("compensable period"). For example, California provides that a reasonable method for stock option income is to use a compensable period beginning on the grant date and ending on the exercise date.[11]

Even if two states look to the same events (*e.g.*, grant date and exercise date) to determine the compensable period there may be differences based on whether the compensable period covers the full taxable years during which the events occurred, or alternatively, if the compensable period spans the exact dates of the relevant events. For example, in Connecticut, the compensable period is based on the first day of the taxable year of grant and ends on the last day of the taxable year of exercise in the case of an option or the last day of the taxable year of vesting, in the case of restricted stock.[12] Thus, if an employee is granted an option on May 1, 2005 and exercises the

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[10] *See, e.g.,* Conn. Gen. Stat. § 12-705(a) ("Each employer…shall deduct and withhold from such wages for each payroll period a tax computed in such manner as to result, so far as practicable, in withholding from the employee's wages during each calendar year an amount substantially equivalent to the tax reasonably estimated to be due from the employee"); N.Y. Tax Law § 671(a) (Every employer…shall deduct and withhold from such wages for each payroll period a tax computed in such manner as to result, so far as practicable, in withholding from the employee's wages during each calendar year an amount substantially equivalent to the tax reasonably estimated to be due under this article").

[11] Cal. FTB Publication 1004 (March 2005).

[12] *See* Conn. Gen. Stat. § 12-711 (allocations in general); Conn. Agencies Regs. § 12-711(b)-16 (incentive stock options); Conn. Agencies Regs. § 12-711(b)-17 (restricted stock); Conn. Agencies Regs. § 12-711(b)-18 (nonstatutory stock options).

option on June 20, 2008, the allocation will be based on the days worked within and without Connecticut during the period from January 1, 2005 until December 31, 2008.

The treatment of deferred equity compensation in New York has recently been the center of much controversy as a result of the New York State Tax Appeal Tribunal's decision in *Matter of Stuckless*.[13] In 1995, the New York State Department of Taxation and Finance ("Department") issued TSB-M-95(3)I, which provided for a compensable period beginning on the date of grant and ending on the date of exercise, in the case of options, or the date of vesting, in the case of restricted stock. In *Stuckless*, the taxpayer sought to allocate option income based solely on the allocation percentage in the year of exercise, while the Department took the position that the taxpayer must apply the methodology under TSB-M-95(3)I and look at the period between grant and exercise. The Tribunal agreed with the taxpayer and held that New York State Regulation Section 132.18 provides that the allocation of option income should be computed based on the days worked in and out of New York in the taxable year of exercise.

In response to the decision in *Stuckless*, the Department issued TSB-M-06(7)I and proposed regulations to clarify the tax treatment of deferred equity compensation. TSB-M-06(7)I explains that for tax years prior to 2006, the Department will accept the allocation under TSB-M-95(3)I and the allocation under *Stuckless*. Beginning with tax year 2006, the proposed regulations provide for a compensable period starting on the date of grant and ending on the date of vesting, irrespective of the type of equity. For tax year 2006, the proposed regulations provide that a transition rule will allow a taxpayer to elect to treat the deferred equity compensation under the rules of TSB-M-95(3)I.

Employee Relations Issues

A major concern for employers that do institute procedures for tracking employee movements and withholding in multiple states is the likely backlash from employees. Employees are typically content to be subject to withholding in their resident state and the state of their primary work office. However, where an employer is fully compliant with respect to multistate withholding, employees that travel for work purposes on a regular basis face an increased compliance burden and possibly a larger overall state tax liability.

To a great number of employees it is a foreign concept to be subject to tax, and therefore subject to withholding, in multiple states. Employers are facing a critical need to inform and educate their employees regarding state withholding tax laws. Employers should highlight the fact that laws in this area have not changed and employees have, in general, always been subject to tax in states where they are physically present and performing services. Receiving such a message from an employer is difficult to accept because an employee may have been performing services in multiple states for years without the employer withholding on a multistate basis.

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[13] *Matter of Stuckless*, Tax Appeals Tribunal, DTA No. 819319 (August 17, 2006).

Employers may also choose to inform their highly compensated employees, those most likely to be receiving equity based compensation, that they are also at risk on a personal level. A state is more likely to institute an audit with respect to a high-level or highly compensated individual than a moderately compensated mid-level employee. Therefore, it is in the employee's best interest to become compliant, rather than suffer an intrusive prolonged audit that may span multiple years. Furthermore, it is likely that new withholding policies will be more easily instituted on a company-wide basis with less backlash if upper-level management is setting an example and embracing the new policies.

Finally, as will be discussed below, whether to change or institute withholding tax policies may have become less of a "choice" since the passage of Sarbanes-Oxley.

Apportionment Factor Issues

Deferred equity compensation may significantly affect the payroll factor used in apportioning a company's income for corporate tax purposes. Even though the deferred compensation is attributable to multiple periods, many states will include the compensation in the payroll factor for the year the income is recognized. Furthermore, states, in general, do not apportion compensation paid to an employee between multiple states.

The Uniform Division of Income for Tax Purposes Act ("UDITPA") adopted the same test as the Model Unemployment Compensation Act, which will always allocate an employee's compensation to a single state. Under the UDITPA test, an individual's compensation will be attributable to a state if:

a) the individual's service is performed entirely within the state; or

b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

c) some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in the state.[14]

Many states have adopted UDITPA, and even states that have not will generally conform to the uniform rules for sourcing compensation for the payroll factor. For example, Connecticut and Massachusetts have not adopted UDITPA, but still use the

[14] UDITPA § 14.

UDITPA test for allocating the payroll factor.[15] While New York has not adopted UDITPA, it utilizes a similar default test for the payroll factor.[16] However, New York's test excludes compensation paid to general executive officers from the computation of the payroll factor.[17] By excluding the compensation of executive officers (*i.e.*, those employees likely to receive significant sums of equity compensation) the impact of not allocating based on where an employee performs services is lessened in New York.

Many states allow, and UDITPA provides for, an alternate method of apportionment if the taxpayer can establish that the default test provides for an unfair apportionment. However, the burden may be difficult to satisfy in many states. For example, in California the taxpayer must "establish by *clear and convincing* evidence that the regulation does not fairly represent the extent of the taxpayer's activities in this state,"[18] and in Connecticut the taxpayer must prove "by *clear and convincing* evidence, that there are unusual fact situations (which ordinarily will be unique and nonrecurring) producing incongruous results under the statutory apportionment formula."[19] In New York, if a taxpayer establishes that "a substantial part of its payroll was paid to employees attached to an office in New York State who performed a substantial part of their services outside New York State" and that the default test "would not properly reflect the amount of the taxpayer's business done within New York State by its employees," then the taxpayer may be permitted to compute the payroll factor based on "compensation paid for services performed in New York State."[20] The bottom line is that employers have the ability to explore alternate apportionment methodologies that may better reflect their business operations and reduce their overall corporate tax liability.

It is interesting to note that, prior to UDITPA, if compensation was paid to an employee that performed services both within and without a state, the compensation was usually apportioned on a time or productivity basis. UDITPA and states that substantially conform to UDITPA with regard to the payroll factor provide an administratively simple solution by attributing an employee's compensation to one state, even if the employee's services are performed within and without the state. However, if states follow the example set by New York and push employers to track where their employees perform services for withholding purposes, perhaps the rules for calculating the payroll factor should be modified to conform to withholding and personal income tax regimes.

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[15] Conn. Gen. Stat. § 12-218(c)(2); Mass. Gen. Laws ch. 63, § 38(e); 830 Mass Code Regs. 63.38.1(8)(b).

[16] N.Y. Comp. Codes R. & Regs. tit. 20, § 4-5.1(d).

[17] N.Y. Tax Law § 210(3)(a)(3); N.Y. Comp. Codes R. & Regs. tit. 20, § 4-5.1(a).

[18] *Appeal of Fluor Corporation*, No. 95-SBE-016 (Cal. St. Bd. Equal.. Dec. 12, 1995) (emphasis added).

[19] Conn. Agencies Regs. § 12-221a-1(e) (emphasis added).

[20] N.Y. Comp. Codes R. & Regs. tit. 20, § 4-5.1(d) (the regulation provides particular sourcing rules for the compensation). It should be noted that under N.Y. Comp. Codes R. & Regs. tit. 20, § 4-6.1(b), the Commissioner in its own discretion may adjust the overall apportionment "to effect a fair and proper allocation."

Determining the payroll factor in such a manner arguably provides a more accurate apportionment of a business' activities. In addition, permitting businesses to apportion payroll based on where services are performed will, in theory, shift the overall tax burden to out-of-state businesses from those companies that have a base of operations in a particular jurisdiction.

Sarbanes-Oxley § 404

Most corporations have additional pressure to review proper procedures for reporting taxes. Following the corporate reporting scandals in late 2001, Congress passed the Sarbanes-Oxley Act of 2002[21] in an effort to restore confidence and improve integrity of financial reporting. Pursuant to Sarbanes-Oxley Section 404, a public corporation's management is required to provide an assessment on the effectiveness of internal controls over financial reporting, and an auditor is required to report on the effectiveness of internal controls over financial reporting, including management's assessment process. The fact that a corporation should be withholding personal income taxes in a particular state and is not doing so may represent a weakness in their internal controls over financial reporting.

It is the authors' experience that most corporations lack internal control procedures in place to monitor such things as employee movements for determining when a particular state's nexus threshold has been reached, tracking individual employee movements for payroll allocation purposes, and staying abreast of the state rules for withholding on equity based compensation. Accordingly, these issues may need to be addressed when management and external auditors review the internal controls procedures in this area.

Conclusion

State enforcement activities and Sarbanes-Oxley have certainly moved the issue of withholding on equity based compensation at the state level to the forefront. The most effective way for an employer to deal with these issues, and to minimize employee morale issues, is to provide coordination between the Tax, Payroll and Human Resource departments to simplify any needed tracking. Internal coordination, along with some help from Congress, will provide employers the greatest likelihood of implementing the proper procedures and controls to become substantially compliant with the various state tax laws in this area.■

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[21] Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).