STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
ALAIN J. AND HAYDEE L. BELDA	:	
for Redetermination of a Deficiency or Refund of New York State and City Personal Income Taxes under Article 22 of the Tax Law and the New York City Administrative Code for the Year 2001.	:	
In the Matter of the Petition	:	
of	:	DETERMINATION
GEORGE J. AND BETTY A. PIZZEY	:	DTA NOS. 820242, 820243 AND 820244
for Redetermination of a Deficiency or Refund of New York State and City Personal Income Taxes under Article 22 of the Tax Law and the New York City Administrative Code for the Year 2001.	:	
In the Matter of the Petition	:	
of	:	
LAWRENCE PURTELL	:	
for Redetermination of a Deficiency or Refund of New York State and City Personal Income Taxes under Article 22 of the Tax Law and the New York City Administrative Code for the Year 2001.	:	

Petitioners, Alain J. and Haydee L. Belda, 900 Fifth Avenue, New York, New York 10021, George J. and Betty A. Pizzey, 200 Riverside Boulevard., New York, New York 10069,

and Lawrence Purtell, 637 Shoreline Drive, Naples, Florida 34119, filed petitions for redetermination of deficiencies or for refund of New York State and City personal income taxes under Article 22 of the Tax Law and the New York City Administrative Code for the year 2001.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on July 21, 2005, at 10:15 A.M., with all briefs submitted by November 7, 2005, which date began the six-month period for the issuance of this determination. Petitioners appeared by Metz Lewis LLC (Larry S. Blair, Esq., of counsel). The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Kevin R. Law, Esq., of counsel).

ISSUES

I. Whether the income from an incentive compensation plan and a performance enhancement reward plan paid to Mr. Belda, Mr. Pizzey and Mr. Purtell and reported on their respective W-2's for the year 2001 by their employer, Alcoa, Inc., is subject to tax by New York State and New York City.

II. Whether a portion of the income received by Mr. Belda, Mr. Pizzey and Mr. Purtell in 2001 from the exercise of Alcoa nonqualified stock options, granted prior to petitioners' becoming residents of New York, should be taxed based on an allocation of the income within and without New York.[1]

FINDINGS OF FACT

1. Alain P. Belda, George J. Pizzey and Lawrence R. Purtell (hereinafter "petitioners") were employees of Alcoa Inc. ("Alcoa") and New York State and New York City residents

[1]A third issue concerning income attributed to Cheryl L. Purtell was resolved by the parties and noted in post hearing submissions.

during the year 2001.[2] All three petitioners filed New York State resident income tax returns for the full year 2001.

2. Alcoa relocated its headquarters from Pittsburgh, Pennsylvania to New York City in early 2001, thus necessitating the presence of petitioners in the State and City of New York in order to discharge their duties to the corporation.

3. Petitioners each received wage and tax statements ("W-2") from Alcoa for the year 2001 which included compensation from two or more of the following three plans: the incentive compensation plan ("IC Plan"), the performance enhancement reward plan ("PERP"), and the nonstatutory stock option plan ("NSSO").

4. The IC Plan was created by petitioners' employer and set various goals that needed to be achieved during the year 2000 in order for petitioners to become eligible for payout under the plan. If a plan participant met the goals set forth, then the compensation committee would award that participant with a stipend when it met in 2001.

5. The PERP was a plan designed by petitioners' employer in 1998 which encouraged participants to reduce corporate expenses by a certain percentage during the years 1998, 1999 and 2000. If the goals were met, participants became eligible for a payout under the plan, as awarded by the compensation committee when it met in 2001.

6. The NSSO was an employer incentive plan that issued nonstatutory stock options convertible into the employer's stock to plan participants based on services performed.[3] If the participant was an active employee as of the issuance date, the participant became vested in these options on the issuance date. The exercise price was equal to the fair market value of the

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[2] Reference to petitioners throughout this determination refers to Messrs. Belda, Pizzey and Purtell.

[3] The NSSO plan was not submitted into evidence.

company's stock at the time of the grant. The options under these plans had no readily ascertainable value at the time of issue and were exercisable for ten years from the dated granted.

7. In an undated, unsworn letter to Mr. Blair, petitioners' representative, Ronald Hiserodt, Director of Alcoa Compensation and Benefits,[4] further explained the IC and PERP plans as plans under which certain ascertainable goals were set and, if met, the participants became entitled to payments. The IC Plan target was based on achieving certain business unit and overall company financial results for the year, while the PERP plan rewarded employees for meeting certain corporate cost reduction goals for the years 1998, 1999 and 2000.

Mr. Hiserodt explained that the "award date," from Alcoa's perspective, was "no later than" February 1st of the calendar year following the award year. However, the actual language as set forth in the Incentive Compensation Plan, revised January 1, 1993, defines the award date as February 1st or "as may be otherwise designated by the Committee." In this matter, pursuant to the IC Plan, the award year was 2000 and the award date February 1, 2001. Mr. Hiserodt claimed that the award date did not allow for any change in the amount determined to be due as of December 31, 2000 and that the incentive compensation committee met on January 12, 2001, approved the awards and began notification of the recipients.

8. In contrast, Article III, Section 1, of the Incentive Compensation Plan states:

> Determination. For each Award Year, the Committee shall make awards on the Award Date to such eligible employees in such individual amounts *as it deems appropriate* under the circumstances including *conditions in the general economy and in the aluminum industry*. (Emphasis added.)

[4]Mr. McClane, Alcoa's controller, testified that Mr. Hiserodt had retired from the company in 2004, but had served as the company's liaison with the compensation committee, and presented the IC Plan, PERP and Stock Option Plan to the committee for their approval.

The aggregate amount of awards for any award year could not exceed a predetermined sum set by the compensation committee in accordance with its own procedures. (Article II, Section 3.)

9. Article V, Section 1, of the IC Plan provided that the incentive compensation committee, appointed by the board, had exclusive power and authority to interpret and administer the plan, and was authorized to take all appropriate action, including the adoption of rules and regulations, for the administration of the plan, with all said actions final and binding.[5] The compensation committee of the board was responsible exclusively for awards to officers. Petitioners did not elaborate on the two committees.

10. Mr. Hiserodt explained that, in his opinion, this language did not authorize the committee to change the amount of the award which had been set as of December 31, 2000; rather, it related to the fact that the committee was involved in the compensation process throughout the year. As Mr. Hiserodt stated in his letter:

> Based on achieving the goals, the [corporate] liability was created at December 31, 2000. The Compensation Committee was not able to change the December 31, 2000 liability after December 31, 2000. The liability accrues based on the set criteria. The role of the Compensation Committee after the award year for the award year is to provide an overall review of management's year-end determination of the IC and PERP amounts for the 2000 award year and validate that the goals were in fact met.

However, the IC Plan, Article III, Section 2, provided that the cash payment of awards was to be made from the general funds of the company, although the company could choose to create trusts or special funds. There was no evidence submitted to prove the existence of such special accounts.

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[5]The IC Plan defined "Committee" as the incentive compensation committee, and, with respect to officers of the company, the compensation committee of the board.

11. The PERP was approved by Alcoa in 1998 as part of the company's three-year cost reduction initiative.[6] It called for cash incentives to be paid to eligible participants if the company and those participants met certain aggressive financial goals. Specifically, the goals related to a target return on capital and reduction in cost of goods sold as a percentage of sales, capital as a percentage of sales and overhead expenses during the period 1998, 1999 and 2000. These goals were met and the company made a one-time payment to petitioners, as eligible employees, in January 2001.

Petitioners submitted an unidentified, two-page document entitled "Common Questions and Answers on the Performance Enhancement Reward Program," which was not accompanied by any explanation, credible testimony or documentation. It stated that awards under the PERP would be made in 2001, and that awards would be limited by "how well the corporation does versus the overall corporate threshold and target." It also provided that the corporate "pot" could limit the individual business unit payouts.

12. For both plans, the corporate liability was accrued and deducted on the 2000 Alcoa audited financial statements, which were provided to shareholders, lenders and other interested public parties, as well as submitted to the Securities and Exchange Commission. The amounts were also accounted for on the consolidated balance sheet as liabilities entitled "Accrued compensation and retirement costs" in the sum of $928,000,000.00. This figure is further described on a financial schedule prepared for the hearing entitled, "Accrued Compensation and Retirement Costs," which contains an entry for accrued variable compensation salary containing the IC Plan and PERP in the sum of $173,770,185.00 as of December 31, 2000. For purposes of the IC Plan and the PERP, the eligible employees' performance was measured only up to

[6]The PERP was not submitted into evidence.

December 31, 2000. Performance after that date was not considered for purposes of their incentive payments. The plans were subject to continual review and goals were sometimes modified within performance periods to reflect actual business conditions.

13. In arriving at New York adjusted gross income, petitioner Alain Belda subtracted what he termed "income earned and accrued prior to New York residency" in the sum of $2,639,900.00. This represented payment from the IC Plan in the amount of $1,641,500.00 and a payment of $998,400.00 from the PERP.

14. In arriving at New York adjusted gross income, petitioner George Pizzey subtracted what he termed "income earned and accrued prior to New York residency" in the sum of $671,673.00. Of this amount, $247,888.00 represented a payment from the IC Plan and $423,785.00 represented a payment from the PERP. In addition, there was a subtraction of $62,035.00 which represented the gain on the sale of a home in Australia. The Division's disallowance of the subtraction deduction for the gain on the sale of the home was not disputed in this proceeding.

15. In arriving at New York adjusted gross income, petitioner Lawrence Purtell subtracted what he termed "income accrued prior to becoming a resident" in the sum of $1,258,571.00 and "income earned by a nonresident spouse" in the sum of $111,818.00.[7] Of Mr. Purtell's purportedly accrued income of $1,258,571.00, $270,537.00 represented a payment from the IC Plan, $604,819.00 a payment from the PERP and $383,215.00 represented nonqualified stock option income paid pursuant to the NSSO.

[7]As noted above, the issue with respect to Mrs. Purtell's income has been resolved by the parties. The parties agreed that $82,950.00 was Mrs. Purtell's income and should not be reported on Mr. Purtell's New York State return for 2001. It is assumed the remainder, $28,868.00, is properly includible in Mr. Purtell's return.

16. Under the NSSO program, Alcoa granted the employee an option with a price equal to the fair market value of the underlying stock at the date of the grant. Upon exercise, typically at ten years, the employee recognized ordinary income that was reflected as compensation on the W-2. Petitioner Lawrence Purtell exercised certain options in 2001 that had been granted to him in prior years. The full amount of the income was reported by Alcoa as New York wages. Mr. Purtell believed that only a portion of the income should have been allocated to New York. He allocated the non-New York portion of the payment from the NSSO using a formula that took total non-New York business days in the period from grant to exercise of the option and divided that number by the total business days in the same period, which was then multiplied by the stock option income. The remaining income was allocated to New York and reported on the 2001 resident income tax return.

17. Attached to petitioners' 2001 New York State income tax returns was a statement in support of the subtractions from Federal adjusted gross income which read as follows:

> The taxpayer became a resident or part-year resident of New York during 2001. Prior to becoming [a] resident in New York, the taxpayer had earned and accrued elements of compensation that had been reported in taxpayer's New York compensation (on Form W-2) and subjected to New York State tax and New York City tax withholding. Since these amounts are not subject to any New York taxes based on statute, regulation, or interpretation of the New York law, these income amounts are being deducted from the reported New York compensation.

18. After a review of petitioners' returns, the Division of Taxation issued to each petitioner a Statement of Proposed Audit Changes, indicating that the Division had made a recomputation of the return and that a balance was due. In each of the statements, appeared the following language:

> As a resident of New York State, you are subject to tax on all income reported on your federal return regardless of where the income was earned.

19. On October 28, 2002, the Division issued a Statement of Proposed Audit Changes to Mr. and Mrs. Belda in which it set forth the changes it made to their 2001 New York State Resident Income Tax Return, which resulted in additional New York State personal income tax of $164,264.73, New York City tax of $42,215.14 and interest of $6,760.38 for a total due of $213,240.25.

On January 23, 2003, the Division issued to Mr. and Mrs. Belda a Notice of Deficiency for the year 2001 which set forth the same amount of additional personal income tax due as asserted in the Statement of Proposed Audit Adjustment plus interest of $9,831.66 for a total amount due of $216,311.53.

20. On October 7, 2002, the Division issued a Statement of Proposed Audit Changes to Mr. and Mrs. Pizzey in which it set forth the changes it made to their 2001 New York State Resident Income Tax Return, which resulted in additional New York City personal income tax of $13,998.44 and interest of $408.51 for a total due of $14,406.95.

On December 26, 2002, the Division issued to Mr. and Mrs. Pizzey a Notice of Deficiency which asserted additional New York City income tax for the year 2001of $13,998.44 and interest of $599.21 for a total due of $14,597.65.

21. On October 28, 2002, the Division issued to Mr. Purtell a Statement of Proposed Audit Changes which indicated the changes it made to his 2001 New York State Resident Income Tax Return and set forth additional New York City personal income tax of $27,497.67 and interest of $900.30 for a total amount due of $28,397.97.

On January 23, 2003, the Division issued to Mr. Purtell a Notice of Deficiency which asserted additional New York City income tax for the year 2001 in the sum of $27,497.67 and interest of $1,309.31 for a total due of $28,806.98.[8]

22. In his petition, Mr. Belda summarized the entries on his 2001 New York State personal income tax return and his claim for refund as follows:

New York Income	$14,954,799.00
IC and PERP Income	(2,639,900.00)
Non-NY bond Income	44,184.00
New York AGI	12,314,899.00
New York State and City Tax	1,279,901.00
Payments	1,349,079.00
Refund Requested on Return	$69,178.00
Adjustment for Exercise of Nonqualified Stock Options	7,843,405.00
Tax on Adjustment for Stock Option Income	921,600.00
Total Refund Request per Petition	$990,778.00

23. In his petition, Mr. Pizzey summarized the entries on his 2001 New York State personal income tax return and his claim for refund as follows:

New York Income	$3,516,86.00
IC and PERP Income	
Capital Gain (Australian Home)	(733,708.00)
New York AGI	2,783,161.00
New York State and City Tax	288,821.00
Payments	351,436.00
Refund Requested on Return	$62,615.00
Adjustment for Exercise of Nonqualified Stock Options	1,247,529.00
Tax on Adjustment for Stock Option Income	146,585.00
Total Refund Request per Petition	$209,200.00

24. In his petition, Mr. Purtell summarized the entries on his 2001 New York State personal income tax return and his claim for refund as follows:

[8]The Division recalculated the tax due for Mr. Pizzey and Mr. Purtell and in so doing applied withholding to the New York State tax liability, which resulted in all New York State tax being paid.

New York Income	$2,188,812.00
IC and PERP Income	
Stock Option Income	
State Refund	
Spousal Income	(1,387,637.00)
New York AGI	801,175.00
New York State and City Tax	81,835.00
Payments	197,434.00
Refund Requested on Return	$115,599.00
Adjustment for Exercise of Nonqualified Stock Options (Additional)	$34,296.00
Tax on Adjustment for Stock Option Income	4,030.00
Total Refund Request per Petition	$119,629.00

25. In preparing the 2001 New York State tax returns for petitioners Belda and Pizzey, no income from the exercise of nonqualified stock options was excluded. However, as stated above, $383,215.00 in income from the exercise of the nonqualified stock options was excluded from the 2001 New York State tax return by petitioner Purtell.

26. Both petitioner Belda and petitioner Pizzey have requested that they receive a refund of tax paid on the income they failed to exclude which was derived from the exercise of the nonqualified stock options in 2001. Petitioner Belda requested a refund of $921,600.00, while petitioner Pizzey requested a refund of $146,584.65. The refunds were calculated on the basis of an allocation formula identical to the one set forth in Finding of Fact "16" and utilized by petitioner Purtell to allocate his income from the exercise of similar options. The non-New York portion of the payment from the NSSO was allocated using a formula that took total non-New York business days in the period from grant to exercise of the option and divided that number by the total business days in the same period, which was then multiplied by the stock option income. The Division of Taxation did not dispute petitioners' calculation of non-New York and total business days used in the allocation formula.

SUMMARY OF THE PARTIES' POSITIONS

27. Petitioners argue that the corporate liabilities for the amounts paid to them in 2001 from Alcoa's IC Plan and the PERP were fixed and determinable as of December 31, 2000, and since they were nonresidents of New York State at all times on or before December 31, 2000, they should not be subject to either New York State or New York City personal income tax on this income.

28. Petitioners contend that the income they were paid in 2001 from the exercise of the Alcoa nonstatutory stock options should be subject to New York State and New York City personal income tax based on an allocation percentage determined by dividing the New York working days in the period from grant to exercise of the option by the total number of working days in the period from grant to exercise and then applying this percentage to the income derived from the exercise of the options.

29. The Division of Taxation argues that petitioners have not sustained their burden of proof that the wage income generated by the IC Plan and the PERP which was received in 2001 when they were New York residents accrued prior to their New York residency. Relying on Internal Revenue Code ("IRC") § 451, the Treasury Regulations and the cases decided thereunder, the Division maintains that the income received from the incentive plans is includible in income when all events have occurred that fix the taxpayers' right to receive the income and the amount can be determined with reasonable accuracy. The Division argues that this took place when the compensation committee approved the payment of the income in 2001 and it is therefore includible in New York income.

30. The Division contends that the income received on the exercise of a nonqualified stock option by a resident taxpayer is fully taxable regardless of the taxpayer's status as a

nonresident at the time of the grant of the option. The Division points out that the income generated by nonstatutory stock options, which have no ascertainable fair market value at the time of the grant, is realized when the option is exercised or otherwise disposed of, and there is no provision in the New York Tax Law which permits reducing Federal adjusted gross income based upon the allocation formula petitioners utilized. The Division believes that petitioners, as New York residents, realized income on the exercise of their options which is fully taxable by New York State and New York City.

CONCLUSIONS OF LAW

A. Tax Law § 639(b) provides, in part, as follows:

> If an individual changes status from nonresident to resident he shall, regardless of his method of accounting, accrue to the period of nonresidence any items of income, gain, loss or deduction . . . accruing prior to the change of status . . . .

The regulations repeat the same provision at 20 NYCRR 154.10(e), stating:

> Where the resident status of an individual or of a trust changes from nonresident to resident, such individual or trust must, regardless of the method of accounting normally employed, accrue, for the portion of the year prior to such change, any items of income, gain, loss or deduction accruing prior to the change of resident status.

The rules governing how much, when and whether items are to be accrued are found in IRC § 451[9]:

> The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

[9]In the absence of New York case law, it is appropriate to look to the Federal interpretation of similar language in the Internal Revenue Code. (***Matter of Yellin v. Tax Commission***, 81 AD2d 196, 440 NYS2d 382.)

The regulation promulgated thereunder provides that the general rule for taxable year of inclusion of such income is, in part, as follows:

> Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.
>
> (Treas Reg § 1.451-1[a].)

B. The first issue to be determined in this matter is whether the income received by petitioners from the IC Plan and the PERP accrued to the period of nonresidence, i.e., prior to January 1, 2001. For both plans, the relevant inquiry, as indicated by Treas Reg § 1.451-1(a), is two-fold: whether all the events which fixed the right to receive the income occurred and whether the amount of the income was determined with reasonable accuracy by December 31, 2000.

The IC Plan document specifically provided that the compensation committee made awards in its discretion, taking into account the conditions of the general economy and the aluminum industry, on February 1st of the calendar year following the award year. Further, the committee had the exclusive power and authority to interpret and administer the IC Plan and make awards to eligible employees. The committee was also authorized to take all action, including the adoption of rules and regulations, for the administration of the plan, and all determinations by the committee were final and binding.

Petitioners contend that the award by the committee in 2001 was a ministerial act or formality that did not change the fixed and determined nature of the awards that accrued as of December 31, 2000. In support of this position, they offered the undated, unsworn letter of Ronald Hiserodt to Mr. Blair. Mr. Hiserodt was formerly the director of compensation and

benefits at Alcoa, but there was no evidence that he drafted or assisted in drafting the Incentive Compensation Plan or of any foundation for his interpretations and extrapolations of the language in that document. An example of this was his statement that the "operation"of Article III, Section 1, of the IC Plan did not allow the compensation committee to change the amount of the liability for the preceding year and that the committee was involved with the compensation process throughout the calendar year (intimating that the committee's active involvement was during the award year, not after). Mr. Hiserodt never disclosed the source of his knowledge for this assertion, which does not appear to be supported by a rule, regulation or interpretation of the compensation committee, which was vested with exclusive power and authority to interpret and administer the plan (Article V, Section 1). Further, it was not disclosed, and Mr. Hiserodt did not mention, if the compensation committee established a separate trust fund for the awards which might have demonstrated that the funds were segregated and fixed as of December 31, 2000. Also, the balance sheet is not proof that petitioners' awards were fixed at December 31, 2000. Only the schedule prepared for hearing indicated the accrued variable compensation item, and even that figure does not specifically identify the amount of petitioners' awards.

Compounding the problems with Mr. Hiserodt's unsworn letter and the assertions he makes therein, is the fact that he was not available to elaborate on his knowledge of the two plans and supply clarification of obvious conflicts between the IC Plan's terms and his opinion. The Division of Taxation was placed at a distinct disadvantage, since it was unable to cross-examine him with respect to interpretations upon which petitioners seek to rely. Therefore, his letter can be accorded very little weight. Petitioners also failed to provide the testimony of a member of the compensation committee, who would have had personal knowledge of both plans the committee administered.

While Alcoa carried a liability on its books for the accrued variable compensation, that is far from proof that the awards made under the IC Plan and PERP were fixed and determined vis-a-vis petitioners as of December 31, 2000. When looked at in its entirety, the IC Plan was formulated by the committee in early 2000 when goals were set, modified as necessary during the year as projections and expectations were met or missed, and then reviewed early in the next year. The IC Plan was clear in its terms that the aggregate amount of all awards was limited by a specific formula devised by the compensation committee and that the committee made its awards on the award date, February 1st of the year following the award year, "in such individual amounts" as it deemed appropriate "under the circumstances including conditions in the general economy and in the aluminum industry."

For purposes of the IC Plan, it is concluded that the language of the plan document itself indicated that a predetermined aggregate amount was set, which established a ceiling for the awards and that the committee made its awards to eligible employees, including petitioners, on the award date, with the discretion to modify the awards based on prevailing conditions in the economy and industry. It may be that a modification on the award date was a remote possibility, but it was provided for in the plan to afford the committee and, therefore, the company, with ultimate control over the company's finances. Such a provision cannot be viewed as creating merely a ministerial act or formality, and until the committee made its award on the award date all events had not occurred which fixed petitioners' right to receive the income when the amount thereof could be determined with reasonable accuracy. (Treas Reg § 1.451-1[a].)

C. Unlike the IC Plan, the PERP was not supported by any documentation other than an unidentified sheet entitled, "Common Questions and Answers on Performance Enhancement Reward Program," attached to the IC Plan in evidence. However, in this document, that was not

supported by testimony or other documentation, it stated that payments would be made in the first quarter of 2001 and that payment amounts would be limited by "how well the corporation does versus the overall corporate threshold and target." Interestingly, it also noted that there was a possibility that the size of the corporate "pot" could limit individual business unit payouts. These statements, although not demonstrated to be actual provisions of the PERP (since the plan document was not submitted into evidence), certainly raise serious questions as to whether the awards were fixed as of December 31, 2000, or subject to review and modification in 2001, the year in which the awards were made. Further, if, as it appears they do, petitioners maintain the same arguments for the PERP meeting the requirements of the "all events test" of Treas Reg § 1.451-1(a) as the IC Plan, then it must fail for the same reasons set forth above with respect to the IC Plan.

In any event, petitioners' failure to submit the PERP document, provide credible supporting documentary or testimonial evidence or even sworn affidavits from persons with personal knowledge of the PERP presents an insurmountable obstacle to meeting their burden of proof.

D. Tax Law § 612(a) provides, in part, as follows:

> The New York adjusted gross income of a resident individual means his federal adjusted gross income as defined in the laws of the United States for the taxable year, with the modifications specified in this section.

Tax Law § 612(c) provides the modifications which reduce the Federal adjusted gross income, none of which apply to the income received by a resident taxpayer from the exercise of nonstatutory stock options which were granted to the taxpayer while a nonresident. Accordingly, there is no provision for the exclusion of the income realized by petitioners herein

for modifying their Federal adjusted gross income by any portion of the income received on the exercise of their nonstatutory stock options.

Each of the petitioners received nonstatutory stock options while nonresidents of New York. Nonstatutory stock options are granted to an employee in connection with the performance of services and result in compensation income to the service provider. (IRC § 83; Treas Reg § 1.83-7[a].) For Federal purposes, where the options do not have a readily ascertainable fair market value, the provisions of IRC § 83 do not apply and no income is recognized at the time of the grant. Instead, the income is recognized at the time of exercise in an amount equal to the fair market value of the stock less the option price.

Petitioners exercised options received prior to 2001 at various times in the year 2001, which resulted in additional income reported on their W-2's and from which New York State and New York City taxes were withheld.

However, petitioners maintain that the options were received for services performed in prior years while they were residents of other jurisdictions. Therefore, they contend that New York should not have taxed the entire amount of the income recognized from the exercise of the options. (***See,*** Tax Law § 631[b][1][B]; 20 NYCRR 132.4[b] [addressing New York source income of *nonresident* individuals].) Proceeding on the incorrect assumption that they should be accorded the status of nonresidents for the year 2001 for allocation purposes only, petitioners argue that the income should be allocated or apportioned based upon a formula rooted in the apportionment of income for nonresidents, whereby they would pay tax to New York based upon a formula found in 20 NYCRR 132.18, which allocates income based upon a ratio of working days employed in New York to total working days employed both within and without New York.

Petitioners were New York residents for all of 2001 and, as such, were subject to all applicable laws and regulations. Specifically, Tax Law § 612(a) defines a resident's adjusted gross income as his Federal adjusted gross income with the permitted modifications for decreasing the Federal adjusted gross income set forth in Tax Law § 612(c). The compensation received in 2001 for the exercise of nonqualified stock options with no readily ascertainable value at the time of grant and reported on a W-2 is 2001 income for purposes of the Federal law (Treas Reg § 1.83-7[a].) The rationale for this provision is that an option that lacks a readily ascertainable fair market value, like those in the instant matter, will have a specific value only when exercised, thus making that moment the proper time to tax the income derived therefrom. The same rationale defeats petitioners' allocation argument. The options and the underlying stock they represent do not have a fixed value until the time they are exercised. The allocation formula which they argue accurately apportions the value of the income to each jurisdiction does not achieve that goal. By definition, the options did not have a readily ascertainable fair market value until they were exercised and saying they had a specific value prior to that time does not make it so. It only creates a fiction with no basis in the law or regulations applicable to resident taxpayers.

Although helpful in explaining the treatment of certain stock options, ***Matter of Stuckless*** (Tax Appeals Tribunal, May 12, 2005)[10] and ***Matter of Michaelson v. New York State Tax Commn.*** (67 NY2d 579, 505 NYS2d 585) both concerned the taxation of New York source income of nonresidents. Therefore, neither of those cases is helpful in resolving the issue herein. In ***Michaelsen***, the Court of Appeals decided that the proper method of valuing the compensation derived from an option that has no readily ascertainable fair market value on the

[10]The ***Stuckless*** matter has been reargued and is pending before the Tax Appeals Tribunal.

date it is granted is to subtract the option price from the fair market value of the stock on the date the option is exercised. In ***Michaelsen***, the stock was not disposed of on the exercise date and the Court held that any increase in the value of the stock after that date was properly treated as investment income rather than compensation, on which Michaelsen, a nonresident, could not be taxed. The Court never discussed an allocation of the income.

In ***Stuckless***, the Tax Appeals Tribunal held that a nonresident should be taxed on the value of stock which attached to it on the grant and exercise dates. Once that value was derived, the Tribunal allocated a portion to New York which it said was an attempt to allocate to New York the compensation derived from New York employment.

As mentioned, the cases are clearly distinguishable for the simple reason that petitioners herein were residents in 2001, and all of the income realized on the exercise and sale of the stock was taxable by New York. The options had no readily ascertainable fair market until they were exercised in New York in 2001, and to assign a value prior to that time would be mere speculation. Petitioners, conceding this point, attempted to apply the allocation formula used to apportion the income of nonresidents to the facts of this case, but lacked statutory or regulatory authority for doing so.

E. The petitions of Alain J. and Haydee L. Belda and George J. and Betty A. Pizzey are denied, and the notices of deficiency, dated January 23, 2003 and December 26, 2002, are sustained. The petition of Lawrence Purtell is granted to the extent of the agreement between the

parties as set forth in Finding of Fact "15" and footnote "7" thereunder, but in all other respects is denied and the Notice of Deficiency, dated, January 23, 2003, is sustained.

DATED: Troy, New York
May 4, 2006

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE