



Be Ready for New State Taxes on Equity Comp

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Cash-strapped states ramp up efforts to collect their share of equity income from resident executives who received their awards elsewhere.

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It is increasingly common for executives to provide services in more than one state after receiving an equity compensation award, whether it be stock options, stock appreciation rights, restricted stock, or restricted stock units. These awards often vest over 3 to 5 years, and stock options typically may be exercised up to 10 years after the grant date.

While it is well recognized that assignments outside of the United States can create foreign tax issues for executives with respect to equity compensation awards, considerably less attention has been paid to potential state income-tax liabilities when executives regularly provide services in a state other than their state of residence or relocate to another state.

In need of additional revenue, some states are becoming increasingly aggressive about assessing taxes against nonresidents who previously provided services within their borders after receiving an equity compensation award. To avoid potential roadblocks in the courts, some states have enacted legislation to clarify the tax rules applicable to equity compensation awards held by nonresidents. Currently, there are no federal-law restraints on states' ability to tax these awards. That is in significant contrast to compensation that is in the form of retirement income; federal law significantly restricts states' ability to tax nonresidents on this type of income.

Making this issue with equity compensation even more difficult is that there are no uniform rules as to how the value of an equity compensation award is to be allocated or "sourced" among the states. Rules for sourcing vary significantly; some states look to physical presence during the vesting period, while others look to physical presence during the period between the grant date and the delivery of shares or a prescribed number of prior years of service. And, to make matters worse, these rules can vary based on the type of award and whether the individual was actually a "resident" of the state in a prior year. Just figuring out the rules is a significant headache.

The patchwork of state tax rules creates tax-compliance issues for the employer. As a general rule, state income-tax withholding obligations are imposed on employers with respect to the portion of compensation income that is attributable or sourced to that state. Tax withholding is not just based on the state of the executive's residence at the time of receiving payment in most instances. What's particularly vexing is that records might not be easily accessible to figure out the appropriate sourcing, even when one knows the rules.

There are also significant issues for executives. Those who retire to a no-income-tax state (such as Florida) often presume that any compensation payment received will not be subject to state income tax. Learning about the rules after retirement is an unwelcome surprise, particularly when amounts for state taxes are withheld from payments. In addition, if the executive is residing in another state with an income tax at the time of receiving payment under an equity compensation award, there can be difficult tax-credit issues to work through in order to avoid double tax.

Failure to address these issues prior to a taxable event, particularly with respect to states that are aggressively pursuing taxes on equity compensation earned by nonresidents, can result in significant risks. It is important to understand the rules for the states in which executives spend significant time, and to have reliable ways to track this time (consistent with practical constraints) in order to meet withholding and reporting requirements. In some cases, it may be appropriate to provide tax gross-ups, particularly for services in another state for the employer's convenience on a special project.

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