

**STATE OF NORTH CAROLINA**  
**COUNTY OF WAKE**

**BEFORE THE**  
**SECRETARY OF REVENUE**

**IN THE MATTER OF:**

The Denial of Individual Income Tax )  
Refund for the Taxable Year 1999 by the )  
Secretary of Revenue of North Carolina )  
)  
)  
vs. )  
)  
)  
Taxpayers )

**FINAL DECISION**  
Docket No. 2004-200

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on August 18, 2004, upon an application for hearing by Taxpayers, hereinafter referred to collectively as "Taxpayers" and separately as "Husband" and "Wife," respectively, wherein they protested the denial of refund of individual income tax for the taxable year 1999. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayers' attorneys, hereinafter referred to collectively as "Attorneys," and W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division.

On January 28, 2003, the Department of Revenue received an amended 1999 individual income tax return from Taxpayers requesting a refund of \$225,978.00. Upon examination of the amended return, the Department determined that the adjustments reflected on the return were incorrect. A letter denying the refund claimed on the amended return was mailed to Taxpayers on January 14, 2004. Husband objected to the refund denial and timely requested a hearing before the Secretary of Revenue.

**ISSUE**

The issue to be decided in this matter is as follows:

Is the denial of refund for the taxable year 1999 lawful and proper?

## EVIDENCE

The evidence presented by W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division, consisted of the following:

1. Memorandum from E. Norris Tolson, Secretary of Revenue, to Eugene J. Cella, Assistant Secretary for Administrative Tax Hearings, dated May 16, 2001, a copy of which is designated as Exhibit PT-1.
2. Taxpayers' amended North Carolina individual income tax return for the taxable year 1999 with related attachments, copies of which are collectively designated as Exhibit PT-2.
3. Letter from J. E. McGhee, Revenue Tax Auditor, to Taxpayers dated January 14, 2004, a copy of which is designated as Exhibit PT-3.
4. Letter from Husband to E. Norris Tolson dated February 9, 2004, a copy of which is designated as Exhibit PT-4.
5. Letter from Nancy R. Pomeranz, Director of the Personal Taxes Division, to Taxpayers dated February 23, 2004, a copy of which is designated as Exhibit PT-5.
6. Letter from Eugene J. Cella to Taxpayers dated April 5, 2004, a copy of which is designated as Exhibit PT-6.
7. Facsimile letter from Attorneys to Linda G. Douglas, Mr. Cella's administrative assistant, dated May 6, 2004, a copy of which is designated as Exhibit PT-7.
8. Letter from Eugene J. Cella to Attorneys dated May 6, 2004, a copy of which is designated as Exhibit PT-8.
9. Facsimile letter from Attorneys to Linda G. Douglas dated June 22, 2004, a copy of which is designated as Exhibit PT-9.
10. Letter from Eugene J. Cella to Attorneys dated June 23, 2004, a copy of which is designated as Exhibit PT-10.

Attorneys presented the following evidence at the hearing:

1. Document entitled Taxpayer Brief, a copy of which is designated as Exhibit TP-1.
2. A timeline chart for the period August 1, 1987 to July 15, 1999, a copy of which is designated as Exhibit TP-2.

At the conclusion of the hearing, the Assistant Secretary allowed Attorneys until September 18, 2004, to submit additional information for the record. On September 17, 2004,

the Assistant Secretary received a letter with related attachments from Attorneys, copies of which are collectively designated as Exhibit TP-3.

**FINDINGS OF FACT**

Based on the foregoing evidence of record, the Assistant Secretary makes the following findings of fact:

1. Husband was an employee of a New Jersey company from August 1, 1987 through May 28, 1999.
2. Taxpayers were residents of New Jersey from August 1, 1987 until July 31, 1991. During this time, Husband was assigned to the company office in New Jersey.
3. Taxpayers were residents of North Carolina from August 1, 1991 until June 7, 1999. During this time, Husband was assigned to the office in North Carolina until his resignation in May 1999.
4. Taxpayers were residents of Texas beginning June 8, 1999 and for all relevant periods thereafter.
5. Husband was a participant in the company's stock option benefit plan during the period beginning January 1, 1990 and ending May 28, 1999. During this time, the company granted nonqualified stock options to Husband as follows:

March 18, 1991 .....	6,800 options granted
March 16, 1992 .....	4,400 options granted
March 7, 1995 .....	16,000 options granted
March 5, 1996 .....	18,000 options granted
March 4, 1997 .....	7,500 options granted
March 3, 1998 .....	3,000 options granted

6. Husband exercised all of his company stock options (55,700 options) on July 15, 1999 and the company withheld both federal and North Carolina income taxes on the amount realized (\$2,924,524).
7. Taxpayers timely filed their North Carolina individual income tax return for the tax year 1999. The return reflected that Taxpayers were part-year residents of North Carolina during 1999 and that \$3,018,762 of their total income of \$3,212,628 was taxable to North Carolina. The return reflected North Carolina taxable income of \$3,012,355 and North Carolina income tax liability of \$232,495. After deducting Husband's income tax withholding of \$209,817, Wife's income tax withholding of \$142, and estimated income tax payments of \$22,000, Taxpayers' return reflected a balance of income tax due of \$536, which was paid when the return was filed.

8. On January 28, 2003, the Department received Taxpayers' 1999 amended income tax return requesting a refund of \$225,978. The amended return excluded income of \$2,924,524 that Husband realized from the exercise of the 55,700 company stock options from North Carolina taxation. None of the information included with the amended return indicated that any of the 55,700 stock options were granted to Husband while he was a nonresident of North Carolina.
9. Attorneys contend that a portion of the income Husband realized when he exercised the stock options should be characterized as capital gain from the sale of an intangible asset and, therefore, such portion would not be subject to North Carolina taxation since Taxpayers were not residents of North Carolina on the date the options were exercised.

### **CONCLUSIONS OF LAW**

Based on the foregoing findings of fact, the Assistant Secretary makes the following conclusions of law:

1. North Carolina law imposes an income tax on the taxable income of every resident of this State and every nonresident deriving income from a business, trade, profession, or occupation carried on in this State.
2. Federal taxable income is the starting point in determining North Carolina taxable income.
3. A part-year resident of North Carolina determines North Carolina taxable income by multiplying federal taxable income, as adjusted, by a fraction, the numerator of which includes gross income derived from all sources during the period the individual was a resident of North Carolina plus any gross income that is derived from a business, trade, profession, or occupation carried on in this State during the period the individual was a nonresident. The denominator of the fraction is the taxpayer's gross income as determined under the Internal Revenue Code ("Code"), as adjusted pursuant to North Carolina statutes.
4. Under Code section 83, nonqualified stock options are deemed to be property transferred in connection with the performance of services and are treated for federal and State purposes as supplemental wages, subject to income tax withholding. Therefore, wage income realized by an individual from nonqualified stock options is attributable to services performed in North Carolina if the options were granted or awarded during the time the individual performed services in North Carolina. The wage income realized from the 48,900 company stock options granted to Husband during the period he performed services in North Carolina for the company (August 1, 1991 through May 28, 1999) are considered North Carolina wages and are subject to North Carolina income tax. The 6,800 company stock options granted to Husband during the period he performed services for the company in New Jersey are not considered North Carolina wages.

5. Pursuant to Treasury Regulation § 1.83-7, if an employee is granted a nonqualified stock option that does not have a readily ascertainable fair market value at the time the option is granted, then the employee will realize compensation income at the time the option is exercised. Because there was no ascertainable fair market value for the company stock options when they were granted, the proper time for Husband to realize and report the wage income attributable to the company stock options is July 15, 1999, the date the options were exercised.
6. Changes in residency between the time nonqualified stock options are granted and the time the options are exercised has no bearing on the taxability of the options to North Carolina. If the options are attributable to services performed in North Carolina, the resulting wage income is taxable to North Carolina regardless of the residency status of the taxpayer at the time the options are exercised.
7. The amount of wage income to be realized when exercising a nonqualified stock option is determined by subtracting the option price from the fair market value of the stock at the time of exercise. Of the \$2,924,524 wage income Husband realized when he exercised his 55,700 company stock options on July 15, 1999, \$2,637,538 is attributable to the 48,900 company stock options granted to Husband during the period he performed services in North Carolina for company and is considered to be North Carolina wages subject to North Carolina income tax.
8. Taxpayers are entitled to a refund of North Carolina income tax equal to the reduction in their North Carolina income tax liability resulting from the exclusion from North Carolina taxation of wage income of \$381,225, which is attributable to the 6,800 company stock options granted to Husband while he was working in New Jersey. The refund of \$29,803 is calculated as follows:

$$\text{Corrected NC taxable income} = (\text{FTI, as adjusted}) \times \frac{(\text{Total NC source income})}{(\text{Total income from all sources})}$$

$$\text{Corrected NC taxable income} = (\$3,204,633) \times \frac{(\$2,637,538)}{(\$3,212,628)}$$

$$\text{Corrected NC taxable income} = (\$3,204,633) \times (.82)$$

$$\text{Corrected NC taxable income} = \$2,627,799$$

Corrected North Carolina income tax liability	\$202,692
Less: North Carolina income tax paid	<u>(\$232,495)</u>
Overpayment to be refunded	<u>(\$ 29,803)</u>

9. The denial of the refund claimed on Taxpayer's 1999 amended individual income tax return, with the exception of the overpayment of \$29,803, is lawful and proper.

## DECISION

Taxpayers have presented the argument that the income realized from nonqualified stock options should be bifurcated into a “pre-vesting” portion and a “post-vesting” portion. The “pre-vesting” portion would be characterized as compensation income and would be equal to the value of the options at the time all of a taxpayer’s rights have become absolute (i.e., vesting). The “post-vesting” portion would be characterized as capital appreciation of an intangible asset and would be equal to the increase in the value of the options between the time the options became exercisable (i.e., vesting date) and the time the options were actually exercised. Taxpayers base their argument on the premise that the income derived from the company stock options represents compensation income only to the extent the income is received for the performance of personal services. Thus, for the period prior to vesting, because the receipt of the options is contingent upon the performance of future services, the options could be characterized as compensation for those services. However, once the options have vested and the taxpayer has an absolute right to exercise the options, Taxpayers argue that there is no basis for claiming that any future appreciation should be characterized as compensation for personal services.

Taxpayers cite three New York cases in support of their position. Those cases are *Pardee v. New York State Tax Commission* 456 NYS2d 459, 89 AD2d 294 (NY App. Div. 1982); *Donahue v. Chu* 479 NYS2d 889, 104 AD2d 523 (NY App. Div. 1984); and *Michaelson v. New York State Tax Commission* 486 NYS2d 479, 107 AD2d 389 (NY App. Div. 1985). *Michaelson* was appealed to the New York Court of Appeals where the Court reversed the Appellate Division ruling with respect to the “post-vesting” appreciation and held that all accretions to wealth occurring prior to exercise of the stock options were to be characterized as compensation

for the performance of services. (505 NYS2d 585, 67 NY2d 579, 496 NE2d 674 (1986)).

However, Taxpayers believe that the lower court's ruling was the correct position.

Just as the New York Court of Appeals found in *Michaelsen*, the Assistant Secretary rejects any position that characterizes a portion of the income realized when nonqualified stock options are exercised as something other than compensation for personal services. Under federal law, the income realized when nonqualified stock options are exercised is treated as compensatory income. North Carolina's income tax is imposed on an individual's taxable income and North Carolina law defines "taxable income" as the term is defined in section 63 of the Internal Revenue Code. Unless North Carolina law provides otherwise, items of income included in an individual's federal taxable income that are attributable to North Carolina are also included in the individual's North Carolina taxable income to the same extent and in the same character as for federal purposes. For federal income tax purposes, the granting of nonqualified stock options is deemed to be a transfer of property in connection with the performance of personal services. Under federal tax law, the compensation income resulting from the granting of nonqualified stock options that do not have a readily ascertainable fair market value at the time of grant is realized and reported as wage income at the time the options are exercised. Therefore, the nonqualified stock options granted to Husband during the time he performed services in North Carolina are deemed to be property transferred to Husband in connection with the performance of personal services in North Carolina. The compensation income realized from those options constitutes North Carolina wages and is subject to North Carolina income tax regardless of the residency status of Husband at the time the options are exercised.

Taxpayers have established that Husband was granted 6,800 company stock options while he resided and worked for company in New Jersey, a fact unknown to the Department

prior to the hearing. The Department concedes that Taxpayers are entitled to a refund of \$29,803 for North Carolina income tax paid on the wage income of \$381,225 that was attributable to the 6,800 company stock options. Therefore, it is the decision of the Assistant Secretary for Administrative Tax Hearings that the denial of the refund requested for the taxable year 1999, except for \$29,803, is lawful and proper and hereby sustained.

Made and entered this 14th day of December, 2004.

Signature \_\_\_\_\_

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings  
North Carolina Department of Revenue