

[Date]

[Name],
[Title]
[Company]
[Address]
[Address]

Re: Formal Ruling 13-

Dear [Taxpayer]:

This is a formal ruling for ["you"], regarding income tax withholding requirements for certain stock option proceeds. This ruling is based on representations in your letter of [date], and our telephone conversation of [date].

RULING

You must withhold Vermont income tax related to the employee's Vermont income at the time the stock option is exercised. If the employee is a resident at the time the option is exercised, the entire income will be taxed by Vermont. If the employee is a nonresident at the time the option is exercised, only the income related to services performed in Vermont will be taxed by Vermont. The portion of the income from exercise of the option that is taxable by Vermont will be determined by the employee's number of Vermont days worked for you, as compared to the total number of days worked for you in Vermont and elsewhere, from the option grant date through the vesting date.

FACTS

As we understand the facts, you employ individuals in Vermont and in at least one other state. You sometimes compensate your employees with nonqualified stock options, which vest four years after the grant date. You have asked for guidance on how Vermont would apply its income tax to these stock options, and what your Vermont withholding obligations would be.

DISCUSSION

Vermont income tax law generally follows Federal tax law. 32 V.S.A. § 5820. Under Federal law, a nonqualified stock option is not taxable income to the employee at the time it is granted or vested, unless the option itself has a “readily ascertainable fair market value” (as might be the case if the options are transferable and are themselves publicly traded). Internal Revenue Code (IRC) § 83; Treasury Reg. (Treas. Reg.) § 1.83-1(a). Assuming the option you grant to the employee is not transferable and does not have its own fair market value, it would be taxable compensation income to the employee at the time the option is exercised, which is the first point at which its value may be determined. Treas. Reg. § 1.83-7.

When the option is exercised, the Federal compensation income to the employee is the fair market value of the stock minus the option price paid for the stock. Vermont may also tax all or some of the income at the time of exercise of the option, if the person exercising the option is a resident of Vermont, or if the person exercising the option is a nonresident and the option represents “wages . . . or other income” for performance of services in Vermont. 32 V.S.A. § 5823(b)(3).

If the person is a resident of Vermont at the time the option is exercised, Vermont will tax all the income regardless of where the services underlying the option were performed, because Vermont taxes all income of a resident from whatever source derived. 32 V.S.A. § 5822(a). The resident would be able to claim a credit against the Vermont tax for income tax paid to another state (if any) on that income. 32 V.S.A. § 5825.

If the person is a nonresident at the time the option is exercised, and the option was granted solely for services performed in Vermont, Vermont will tax the entire income from exercise of the option. 32 V.S.A. § 5823(b)(3). If the person is a nonresident and the option represents services performed in Vermont and elsewhere, Vermont will tax only the portion that represents the services performed in Vermont. The Vermont portion will be determined by the number of days the employee worked for you in Vermont, as compared to the total number of days worked for you in Vermont and elsewhere, during the period from the option grant date to and including the vesting date.¹

The employer may deduct the amount taxed to the employee. Treas. Reg. § 1.83-6. The employer must report the amount on the Federal Form W-2, and withhold tax on the amount of compensation. IRC § 3401(a); IRS Pub. 15-B (“Employee Stock Options” section). Vermont tax law provides that an employer who is required to withhold at the Federal level must also withhold for Vermont. 32 V.S.A. § 5841(a). Thus, in the year when the employer withholds Federal income tax related to the exercise of the nonstatutory stock option, the employer must also withhold for Vermont.

Federal law prohibits a state from taxing a nonresident on “retirement income,” even if the retirement income arose out of employment in that state. 4 U.S.C. § 114(a). “Retirement

¹ Other states that allocate based on the period from grant to date of vesting apparently include Idaho, Minnesota, New York and Wisconsin.

income” under that provision includes certain items of “nonqualified deferred compensation,” as defined in Internal Revenue Code Section 3121 (an employment tax section of the Code).

4 U.S.C. § 114(b)(1)(I); 26 U.S.C. § 3121(v)(2)(C). Although a stock option is literally a form of “deferred compensation,” the Treasury Regulations under Section 3121 provide that a stock option will not be considered “deferred compensation” for purposes of Section 3121. Treas. Reg. § 31.3121(b)(4)(ii) (“stock option . . . does not constitute the deferral of compensation for purposes of section 3121(v)(2)”). Thus, a nonqualified stock option is not considered “deferred compensation” under Section 3121, and therefore is not considered “retirement income” for purposes of the Federal prohibition on state taxation of nonresidents under 4 U.S.C. § 114. This means that Federal law does not prohibit Vermont from taxing the nonresident employee on income from exercise of the nonqualified stock option which was granted as compensation for services performed in Vermont.

This ruling does not constitute tax advice regarding Federal tax laws, and those laws are discussed in this ruling only for the purpose of applying Vermont income tax laws as they apply to you.

GENERAL PROVISIONS

This ruling will be made public after deletion of the parties’ names and any information which may identify the parties. A copy of this ruling showing the proposed deletions is attached, and you may request within 30 days that the Commissioner delete any further information that might identify the parties. The final discretion as to deletions rests with the Commissioner.

This ruling is issued solely to the taxpayer and is limited to the facts presented, as affected by current statutes and regulations. Other taxpayers may refer to this ruling, when redacted to

protect confidentiality, to determine the department's general approach, but the Department will not be bound by this ruling in the case of any other taxpayer or in the case of any change in the relevant statutes or regulations.

You have the right to appeal this ruling within 30 days. 3 V.S.A. §§ 808, 815.

Emily Bergquist

Date

Approved:

Mary N. Peterson
Commissioner of Taxes

Date