IT 12-09
Tax Type: Income Tax
Tax Issue: Non-resident Exemption

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
SPRINGFIELD, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS **v.** **JOHN DOE** **Taxpayer**	**Docket # XXXXX** **Acct ID: XXXXX** **Letter ID: XXXXX** **Reporting Period: XX** **Claim for Credit or Refund**

RECOMMENDATION FOR DISPOSITION

Appearances: Matthew S. Crain, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; Jack Black of ABC Law Firm for John Doe

Synopsis:

John Doe ("taxpayer"), who is not a resident of Illinois, filed an Illinois Amended Individual Income Tax Return and Schedule NR for the year 2008. The return requested a refund of an overpayment of taxes for that year. The Department of Revenue ("Department") denied the taxpayer's claim for a refund, and the taxpayer timely protested the denial. The parties filed a Stipulation of Facts with attached exhibits and supporting briefs, and they requested that the matter be decided based on the written submissions. This case concerns stock options and stock appreciation rights ("SARS") that the taxpayer received from his Illinois employer. The taxpayer contends that the novel legal issue in this case is whether the gain on the value of stock options and SARS between the time that they vested and the time that they were liquidated is "compensation" that is allocable to Illinois during 2008. After reviewing the record, it is recommended that this matter be resolved in favor of the Department.

FINDINGS OF FACT:[1]

1. John Doe has never been a resident of Illinois. (Stip. #1)
2. Until June 28, 2007, John Doe was employed by ABC Business, an affiliate of XYZ Business at a location in Illinois. (Stip. #2)
3. As part of his employment, John Doe received certain stock options and stock appreciation rights. (Stip. #3)
4. Those options and rights were disposed of in 2008, after John Doe had ceased employment in Illinois. (Stip. #4)
5. John Doe's employer reported all income from those dispositions and other deferred compensation on W-2 as State wages allocable to Illinois and withheld Illinois income tax on all amounts. (Stip. #5)
6. John Doe filed an IL-1040-X and Schedule NR which removed certain portions of those amounts as non-Illinois allocable income. (Stip. #6)
7. The Claim under the IL-1040-X was denied and John Doe protested the denial. (Stip. #7)
8. John Doe received options at various prices and vesting dates as follows:

    45,503 stock options were vested as follows:

    7,117, exercise price of $43.495; vested and exercised on January 1, 2005, price on exercised date $65.62[2]

    7,116, exercise price of $43.495; vested and exercised on January 1, 2006, price on exercised date $72.40

[1] The Findings of Fact are a verbatim reproduction of the Stipulation of Facts.
[2] Although it is not explained by the parties, the term "exercise price" means the price at which the stock that is subject to the option is purchased. 26 C.F.R. §1.421-1(e). The term "exercise" means to purchase stock pursuant to the option. 26 C.F.R. §1.421-1(f).

5,757, exercise price of $52.585; vested and exercised on January 1, 2005, price on exercised date $65.62

5,756, exercise price of $52.585; vested and exercised on January 1, 2006, price on exercised date $72.40

5,757, exercise price of $52.585; vested and exercised on January 1, 2007, price on exercised date $82.72

4,667, exercise price of $73.95; vested and exercised on January 1, 2006, price on exercised date $72.40[3]

4,666, exercise price of $73.95; vested and exercised on January 1, 2007, price on exercised date $82.72

4,667, exercise price of $73.95; vested and exercised on December 15, 2007, price on exercised date $87.69 (Stip. #8)

9. The options were liquidated in 2008 and John Doe received $1,469,395 in proceeds.[4] (Stip. #9)

10. The position taken on Schedule NR is that the value of the shares upon vesting is allocable to Illinois. Schedule NR is calculated based on the position that the increase in value after vesting is investment income which had no connection to employment. (Stip. #10)

11. The position on Schedule NR is that after vesting, the options were no different than any other investment that John Doe maintained. The value of the options

[3] Although this stipulation indicates that the taxpayer paid $73.95 for the stock when the market price was lower than the exercise price (*i.e.*, a loss on the purchase), the taxpayer apparently included this as a gain in his calculation of the amount to be excluded from his Illinois income.

[4] Although this stipulation states that the options were liquidated in 2008, the previous stipulation indicates that the options were exercised in the years 2005 through 2007. Stock options may be either "exercised or otherwise disposed of." 26 C. F. R. §1.83-7(a). The options cannot be exercised in one year and then sold in another year. If the taxpayer exercised the options and obtained stock, then the "stock" may be sold in another year, but not the "options." In their briefs, the parties generally refer to the liquidation of "stock" that was purchased when the options were exercised. At one point, however, the taxpayer refers to the liquidation of "options." (Rebuttal brief, p. 3) From the stipulations and the briefs, therefore, it is unclear whether the options were exercised and then the stock was subsequently sold, or whether the options were actually sold.

rose or fell with market conditions similarly to any other equity holding of John Doe. (Stip. #11)

12. Schedule NR excluded the amount of increase in value from the exercise date till sale. This amount is computed at $645,966. (Stip. #12)
13. Similarly to the options, John Doe was awarded 10,099 SARS. These rights vested December 15, 2007 at a price of $87.69. (Stip. #13)
14. The rights were sold in 2008 at $88.64 generating $238,419. (Stip. #14)
15. Schedule NR was prepared with the investment portion of the proceeds allocated to Anystate, not Illinois. (Stip. #15)
16. The total allocation to Anystate on Schedule NR is computed at $655,560, leaving $1,198,044 as Illinois allocated income. (Stip. #16)
17. Attached as Exhibits hereto are:

    Exhibit A – Original 2008 IL-1040

    Exhibit B – 2008 Form IL-1040-X with attachments

    Exhibit C – Separation Agreement

    Exhibit D – Copy of Anystate Driver's License showing issue date of August 8, 2007

    Exhibit E – Copy of Anycounty, Anystate Voter's Registration Card showing registration date of August 15, 2007 (Stip. #17)

CONCLUSIONS OF LAW:

Article 3 of the Illinois Income Tax Act ("Act") (35 ILCS 5/101 *et seq.*) concerns "Allocation and Apportionment of Base Income." Section 302 in Article 3 concerns compensation paid to nonresidents and provides, in relevant part, as follows:

Sec. 302. Compensation paid to nonresidents.

> (a) In general. All items of compensation paid in this State (as determined under Section 304(a)(2)(B)) to an individual who is a nonresident at the time of such payment and all items of deduction directly allocable thereto, shall be allocated to this State. 35 ILCS 5/302(a).

Section 304(a)(2)(B)(i) of the Act provides that compensation is paid "in this State" if the individual's service is performed entirely within this State. 35 ILCS 5/304(a)(2)(B)(i). The stipulations in the present case indicate that the taxpayer was employed at a location in Illinois (Stip. #2), so the taxpayer's service was performed entirely within this State. The taxpayer contends, however, that the gain he received in connection with the stock options and stock appreciation rights was not "compensation" within the meaning of section 302, and it is not allocable to Illinois for purposes of the income tax.

The term "compensation" is defined in section 1501(a)(3) of the Act, which provides as follows:

> Sec. 1501. Definitions.
>
> (a) In general. When used in this Act, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof:
>
> …
>
> (3) Compensation. The term "compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services. 35 ILCS 5/1501(a)(3).

The taxpayer admits that a portion of the amount he received in 2008 is "compensation" that is allocable to Illinois. The taxpayer states that "the value of the stock options and SARS upon vesting was allocable to Illinois as compensation." (Taxpayer's brief, p. 3; Stip. #10) The taxpayer claims that the subsequent increase in value (gain) that the taxpayer realized when he liquidated the options and the SARS is "investment income" rather than compensation and is not allocable to Illinois.

It should be noted that the taxpayer's arguments concerning how the gains should be calculated are inconsistent. With respect to the stock options, the taxpayer sometimes argues that the gain should be calculated from the time the stock options are "vested" (Stip. #10, 11, Taxpayer's brief pp. 3, 8, 9, 10), and at other times he argues that it should be calculated from the time the stock options are "exercised." (Taxpayer's brief pp. 1, 4, 5) Because the stipulations indicate that the options were vested and exercised on the same day (Stip. #8), the difference in the arguments in this case is immaterial, although the stipulations with respect to the stock options will be discussed in greater detail later.

With respect to the SARS, the taxpayer sometimes argues that the gain should be calculated from the time the SARS "vested" (Taxpayer's brief pp. 3, 10), at other times he argues that it should be calculated from the time the SARS were "awarded" (Taxpayer's brief pp. 4, 10), and another time he argues that it should be calculated from the time the SARS were "exercised." (Taxpayer's brief p. 1) From the numbers that were provided, it appears that the taxpayer calculated the gain related to the SARS from the time that they vested. For purposes of this recommendation, I will assume that the taxpayer's argument is that the gain should be calculated from the time the SARS vested.

The taxpayer contends that pursuant to section 301(c)(2)(A) of the Act, the gain is not allocable to Illinois because it is investment income. Section 301 provides, in relevant part, as follows:

Sec. 301. General Rule.

(a) Residents. …

(b) Part-year residents. …

(c) Other persons.

> (1) In general. Any item of income or deduction which was taken into account in the computation of base income for the taxable year by any

> person other than a resident and which is referred to in Section 302, 303 or 304 (relating to compensation, nonbusiness income and business income, respectively) shall be allocated to this State only to the extent provided by such section.
>
> (2) Unspecified items. Any item of income or deduction which was taken into account in the computation of base income for the taxable year by any person other than a resident and which is not otherwise specifically allocated or apportioned pursuant to Section 302, 303 or 304 (including, without limitation, interest, dividends, items of income taken into account under the provisions of Sections 401 through 425 of the Internal Revenue Code, and benefit payments received by a beneficiary of a supplemental unemployment benefit trust which is referred to in Section 501(c)(17) of the Internal Revenue Code):
>
> > (A) in the case of an individual, trust, or estate, shall not be allocated to this State; … 35 ILCS 5/301(c)(2)(A).

Under section 301(c)(2)(A), interest and dividend income of a nonresident is not allocable to Illinois. It is also worth noting that investment income that would be a capital gain is referred to in section 303 of the Act, which provides, in part, as follows:

> Sec. 303.
>
> (a) In general. Any item of capital gain or loss, and any item of income from rents or royalties from real or tangible personal property, interest, dividends, and patent or copyright royalties, and prizes awarded under the Illinois Lottery Law, to the extent such item constitutes nonbusiness income, together with any item of deduction directly allocable thereto, shall be allocated by any person other than a resident as provided in this Section.
>
> (b) Capital gains and losses.
>
> …
>
> (3) Intangibles. Capital gains and losses from sales or exchanges of intangible personal property are allocable to this State if the taxpayer had its commercial domicile in this State at the time of such sale or exchange.
>
> …
>
> (g) Cross references.

(1) For allocation of interest and dividends by persons other than residents, see Section 301(c)(2). 35 ILCS 5/303(a), (b)(3), (g)(1).

Under section 303(b)(3), if a nonresident individual has a capital gain from the sale of stock, that gain is not allocable to Illinois. See also 86 Ill. Admin. Code §100.3220(b)(3). Therefore, investment income for a nonresident such as capital gains, interest, and dividends is not allocable to Illinois.

The taxpayer argues that the value of the stock options and SARS upon vesting was allocable to Illinois as compensation, but the increase in value after they vested was investment income and not compensation from employment. The taxpayer states that "[o]nce the stock options and SARS vested, [the] taxpayer's employer no longer had any control over the awards; [the] taxpayer could sell them at will and took all the risk of their value rising or falling with the price of his employer's shares." (Taxpayer's brief, p. 10) The taxpayer claims that the "nature of the income was established when [the] taxpayer took possession [*i.e.*, the asset vested]." *Id*. He contends that before that date, the income was "under the employer's control" and, therefore, is compensation for Illinois services. *Id*. He contends that after that date the income is simply another investment.

Section 909 of the Act allows the Department to pay a refund to the taxpayer if he has overpaid his income tax liabilities. 35 ILCS 5/909. Under section 904(a) of the Act, the Department shall examine a return that has been filed to determine the correct amount of tax. 35 ILCS 5/904(a). The findings of the Department shall be *prima facie* correct and shall be *prima facie* evidence of the correctness of the amount due. *Id*. When the taxpayer seeks to take a deduction from his income for purposes of calculating the tax, the burden of proof is on the taxpayer. Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295 (1st Dist. 1981). In order to meet his burden of proof, the taxpayer's testimony alone is not sufficient. *Id*. at 296. The taxpayer must present sufficient documentary evidence to support his claim. *Id*.

Stock Appreciation Rights

The taxpayer has failed to meet his burden of proving that a portion of the income that he received when he sold his SARS in 2008 was investment income that was not allocable to Illinois. Under section 102 of the Act, if the taxpayer's income was investment income such as interest, dividends, or capital gains for federal income tax purposes, then the same characterization would apply for Illinois income tax purposes. 35 ILCS 5/102. Section 102 of the Act provides, in relevant part, as follows:

> Except as otherwise expressly provided or clearly appearing from the context, any term used in this Act shall have the same meaning as when used in a comparable context in the United States Internal Revenue Code of 1954 … 35 ILCS 5/102.

Nothing in the record indicates that the Internal Revenue Service ("IRS") recognized any portion of the income in connection with the sale of his SARS as investment income. If any of the income was actually investment income such as interest, dividends, or capital gains, then the taxpayer should have reported it as investment income on his federal Form 1040.

The taxpayer acknowledges that the Act is construed consistently with federal laws. He argues, however, that according to the phrase in section 102 that states "[e]xcept as otherwise expressly provided or clearly appearing from the context," the terms in the Act do not necessarily have the same meaning as the terms in the Internal Revenue Code ("Code"). The taxpayer states that the Code does not have a comparable context for the allocation of state income, and to say that the income is taxable because it is part of what is taxable for federal purposes ignores the allocation provisions of the Act. The taxpayer contends that the definition of "compensation" in the Act does not refer to federal adjusted gross income. Compensation must be "remuneration paid to employees for personal services." 35 ILCS 5/1501(a)(3). The taxpayer believes that the gain related to the SARS is not remuneration for personal services within the meaning of section 1501(a)(3) of the Act. The taxpayer believes that it is investment income that is not allocable to Illinois.

The taxpayer's arguments are not persuasive. First, the taxpayer has not shown that the term "compensation" under the Act has a meaning that is different than the same term in the Code. If part of the taxpayer's income was not remuneration paid for personal services, then it would not have been reported as compensation or wages on his federal Form 1040. In addition, neither the record nor the taxpayer's arguments support a finding that part of the income related to the SARS is not "remuneration paid to employees for personal services." 35 ILCS 5/1501(a)(3).

In Revenue Ruling 80-300, the IRS addressed the issue of when an employee is in receipt of income because of the grant to an employee of a stock appreciation right. The Revenue Ruling includes the following: "An SAR entitles the employee to a cash payment equal to the excess of the fair market value of one share of the common stock of the corporation on the date of the exercise of the SAR over the fair market value of a share on the date the SAR was granted to the employee." The Revenue Ruling also states as follows: "SARS are not traded on an established market, and are nonassignable and nontransferable by the grantees." In addition, the Revenue Ruling indicates that the SAR is not exercisable before one year, and if not exercised within 5 years, it will be deemed exercised on the 5th anniversary of the grant.

The holding in Revenue Ruling 80-300 includes the following:

> An employee who possesses stock appreciation rights is not in constructive receipt of income by virtue of the appreciation on the

> employer's stock. The cash payment to which the employee is entitled is includible in gross income in the year a stock appreciation right is exercised." Rev. Rul. 80-300; see also Rev. Rul. 82-121.

In other words, the taxpayer does not include anything in his income when the SARS are granted or vested. When the SARS are exercised, the taxpayer includes the cash payment that he received in his gross income, and that is the compensation for his services.

The taxpayer's contention that only the value of the SARS upon vesting is allocable to Illinois as compensation is without merit because he was not in constructive receipt of the income at that time, and therefore, there was no compensation. When the SARS vested, there was no "remuneration *paid* … for personal services." Emphasis added; 35 ILCS 5/1501(a)(3). The taxpayer did not receive income until the SARS were exercised, and that is when he was paid for his services. The full amount of the income that the taxpayer received when he exercised the SARS is included in his Illinois income as compensation.

In his brief, the taxpayer has cited three cases from other States to support his argument that the gain from the SARS was investment income; all three cases are distinguishable. In Pardee v. State Tax Commission, 89 A. D. 2d 294 (Sup. Ct. N.Y. App. Div. 1982), the court found that gains on the investment of an employer's contributions to a *qualified employee profit-sharing plan* were investment income and not allocated to New York for a nonresident's income tax. In Michaelsen v. New York State Tax Commission, 67 N. Y. 2d 579 (Ct. App. N.Y. 1986), the court considered whether gains from *qualified stock options* (pursuant to section 422 of the Internal Revenue Code) were compensation to a nonresident. The court found that the difference in the value of the stock between the time the options were exercised and the time the stock was sold was "investment income rather than compensation." *Id.* at 585. The investment income was not allocable to New York. Finally, in Molter v. Department of Treasury, 443 Mich. 537 (1993), the court found that the payment of interest from a *qualified deferred compensation plan* (pursuant to section 457 of the Internal Revenue Code) to a nonresident was not subject to Michigan's income tax.

As the emphasized words indicate, none of these cases concern SARS. In addition, as will be noted later, the decisions in Molter and Michaelsen have been rendered moot based on current law. Furthermore, the court in Pardee noted that its decision was in conformity with the federal tax treatment of the income. Pardee, at 298. None of these cases support the taxpayer's contention that a portion of the income received from the SARS is investment income that is not allocable to Illinois.

The taxpayer has also provided the following hypothetical: if the taxpayer had not liquidated the SARS in 2008 but rather held on to them and left them to his wife when he died 20 years later, and then his wife left them to her son 5 years after that, then when the son sells the SARS it would be "absurd" to consider that income to be "compensation." The facts in the taxpayer's hypothetical, however, are not supported by the record. Nothing in the record indicates that the SARS may be held for that long a period of time or that they may be transferred to another person. Also, there may be a time limit as to when SARS can be exercised. Therefore, the taxpayer's hypothetical is not premised on facts in the record.

It is important to note that the stipulations in this case do not indicate when the SARS were "granted" or "awarded." According to the stipulations, the taxpayer was employed in Illinois until June 28, 2007, the SARS were awarded at some unknown time, the SARS vested on December 15, 2007, and the SARS were sold in 2008. Because the SARS vested and were exercised after the taxpayer's employment in Illinois (and they may have been granted after his employment in Illinois), an issue arises as to whether the SARS are "retirement income" or "deferred compensation" that was paid to a nonresident. As the following discussion indicates, even if the SARS were granted and exercised after the taxpayer ended his employment in Illinois, the income that he received from the sale of the SARS is still allocable to Illinois.

Congress enacted a federal statute that limits the power of States to impose income tax on the retirement income of nonresidents. 4 U. S. C. section 114(a), which applies to amounts received after December 31, 1995, provides as follows:

> No State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State). 4 U.S.C. §114(a).

Under this provision, if the SARS were "retirement income" that was paid to the taxpayer, then Illinois income tax would not apply. The term "retirement income" is defined in subsection (b)(1) of section 114 as follows:

> **(b)** For purposes of this section--
>
> **(1)** The term "retirement income" means any income from--
>
> **(A)** a qualified trust under section 401(a) of the Internal Revenue Code of 1986 that is exempt under section 501(a) from taxation;
>
> **(B)** a simplified employee pension as defined in section 408(k) of such Code;
>
> **(C)** an annuity plan described in section 403(a) of such Code;
>
> **(D)** an annuity contract described in section 403(b) of such Code;
>
> **(E)** an individual retirement plan described in section 7701(a)(37) of such Code;

(F) an eligible deferred compensation plan (as defined in section 457 of such Code);[5]

(G) a governmental plan (as defined in section 414(d) of such Code);

(H) a trust described in section 501(c)(18) of such Code; or

(I) any plan, program, or arrangement described in section 3121(v)(2)(C) of such Code (or any plan, program, or arrangement that is in writing, that provides for retirement payments in recognition of prior service to be made to a retired partner, and that is in effect immediately before retirement begins), if such income--

(i) is part of a series of substantially equal periodic payments (not less frequently than annually which may include income described in subparagraphs (A) through (H)) made for--

(I) the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or

(II) a period of not less than 10 years, or

(ii) is a payment received after termination of employment and under a plan, program, or arrangement (to which such employment relates) maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415 of such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply.

The fact that payments may be adjusted from time to time pursuant to such plan, program, or arrangement to limit total disbursements under a predetermined formula, or to provide cost of living or similar adjustments, will not cause the periodic payments provided under such plan, program, or arrangement to fail the "substantially equal periodic payments" test.

Such term includes any retired or retainer pay of a member or former member of a uniform service computed under chapter 71 of title 10, United States Code. 4 U.S.C. §114(b)(1).

---

[5] The court's decision in Molter, *supra*, is rendered moot under this provision because that case concerns the tax treatment of a qualified deferred compensation plan pursuant to section 457 of the Code.

The SARS clearly do not fall under subsections (A) through (H) because they are not covered by any of those provisions of the Code. The question is whether SARS fall under subsection (I) as "any plan, program, or arrangement described in section 3121(v)(2)(C) of such Code." Section 3121(v)(2)(C) defines "nonqualified deferred compensation plans," and the Treasury Regulations for this section include the following:

> The *grant* of a stock option, stock appreciation right, or other stock value right does not constitute the deferral of compensation for purposes of section 3121(v)(2). In addition, amounts received as a result of the *exercise* of a stock option, stock appreciation right, or other stock value right do not result from the deferral of compensation for purposes of section 3121(v)(2) *if such amounts are actually or constructively received in the calendar year of the exercise*. Emphasis added; 26 C.F.R. §31.3121(v)(2)-1(b)(4)(ii).

Because an employee is deemed to be in receipt of income (*i.e.*, the income is actually or constructively received) on the date he or she exercises a stock appreciation right, the exercise of a stock appreciation right does not constitute a deferral of compensation for purposes of section 3121(v)(2). See Rev. Rul. 80-300; 82-121. Because neither the grant nor the exercise of a stock appreciation right is considered a deferral of compensation, SARS do not constitute a "nonqualified deferred compensation plan" under section 3121(v)(2)(C), and the SARS are not "retirement income" under section 114(a). The income that the taxpayer received from the SARS, therefore, is allocable to Illinois as compensation.

Stock Options

The taxpayer has also failed to meet his burden of proving that a portion of the income that he received when he sold his stock options in 2008 was investment income that was not allocable to Illinois. The failure to meet his burden is due primarily to the fact that, as noted earlier, the stipulations with respect to the stock options are confusing. Some of the options had an exercise price that was greater than the price of the stock on the exercise date. If the taxpayer actually paid a price for the stock that was greater than the market price, then there would not have been a gain on the exercise of the option. In addition, the stipulations indicate that the options were "exercised" between the years 2005 and 2007 (Stip. #8), and then they indicate that the options were "liquidated" in 2008. (Stip. #9) Another stipulation states that the options were "disposed of" in 2008. (Stip. #4) Stock options may be either "exercised or otherwise disposed of." 26 C. F. R. §1.83-7(a). Stock options cannot be exercised (*i.e.*, stock is purchased pursuant to the option) and then later liquidated (*i.e.*, the option itself is sold). After an option has been exercised, it cannot be sold. If the taxpayer exercised the options and obtained stock, then the "stock" may be sold in another year, but not the "options." The stipulations, therefore, are very confusing.

In his briefs, the taxpayer sometimes refers to the liquidation of stock that was purchased pursuant to the options (*e.g.*, Taxpayer's brief, p. 10), and another time he refers to the liquidation of options (Rebuttal brief, p. 3). Even the arguments in the taxpayer's briefs, therefore, are not consistent. Because the Department's determination is *prima facie* correct and the taxpayer bears the burden of proving he is entitled to a deduction, the fact that the stipulations are confusing and do not clearly present the taxpayer's case warrants a finding in favor of the Department with respect to the stock options.

Nevertheless, for clarification purposes, the law with respect to stock options will be reviewed. For income tax purposes there are, in general, two types of stock options: statutory (*i.e.*, qualified) and non-statutory (*i.e.*, non-qualified). See 26 C. F. R. §1.421-1(b)(1), (b)(3)(i). The federal and state income tax treatment of stock options varies depending on whether they are qualified or non-qualified. *Id*.; 26 U. S. C. §§421, 422, 423; 26 C. F. R. §1.83-7.

If the taxpayer's options were qualified (pursuant to various provisions of the Code that are included in Sections 401 through 425), then the income related to those options is not allocable to Illinois for a nonresident. See 35 ILCS 5/301(c)(2)(A); 86 Ill. Admin. Code §100.3120(c)(1). The taxpayer would first have to establish that the compensation was properly taken into account under the provisions of 26 USC 401 through 425. If he did, then the income would not be allocable to Illinois.[6] *Id*.

Although not indicated in the stipulations, the parties agree that the taxpayer's stock options were non-qualified. (Taxpayer's brief, p. 4; Department's brief, p. 3) In general, the federal income tax treatment of a non-qualified stock option depends on whether the option has a readily ascertainable fair market value at the time it is granted. 26 C. F. R. §1.83-7(a). If it does, then the taxpayer "realizes compensation" under section 83(a) of the Code when the option is granted. *Id*. If the option does not have a readily ascertainable fair market value at the time of grant, then the taxpayer "realizes compensation" pursuant to sections 83(a) and 83(b) "at the time the option is exercised or otherwise disposed of." *Id*.; see also Rev. Rul. 80-244 (employee realizes compensation under section 83(a) of the Code upon the exercise of a non-qualified stock option that did not have a readily ascertainable fair market value when granted). If an employee receives stock upon the exercise of the option, then for federal income tax purposes, any gain upon the subsequent sale of the stock would generally be a capital gain if the capital gain requirements are met. See Svoboda v. Commissioner of Internal Revenue, T.C. Memo.

[6] The court's decision in Michaelsen, *supra*, is rendered moot pursuant to section 301(c)(2)(A) of the Act and section 100.3120(c)(1) of the Department's regulations because the Michaelsen case concerns the tax treatment of qualified stock options pursuant to section 422 of the Code.

2006-235. As previously stated, under section 102 of the Act, if for federal income tax purposes the taxpayer's income was either compensation or investment income (such as capital gains), then the same characterization would apply for Illinois income tax purposes. 35 ILCS 5/102.

As these rules indicate, additional information concerning the taxpayer's stock options is necessary in order to determine the proper income tax treatment. The federal income tax treatment of the options is essential to determining the state income tax treatment. The record as presented, however, clearly does not support a finding that a portion of the income related to the stock options is not compensation and is not allocable to Illinois.

Recommendation:

For the foregoing reasons, it is recommended that the Department's denial of the taxpayer's claim be upheld.

Linda Olivero
Administrative Law Judge

Enter: December 7, 2012