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Allocation of Income from Restricted Share Units

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The treatment of deferred compensation plans is one of the more complex areas of taxation since there are many different types of arrangements, including deferred cash payments, grants of stock and stock options, and other methods. Determining the New York taxation of nonresident employees who receive deferred compensation adds an additional level of complexity. The recent Administrative Law Determination in *Petition of Dale Adams* (DTA No. 850026 (2024)) demonstrates the difficulties taxpayers, auditors and judges have in deciding how to apply the relevant provisions of the Tax Law.

Initially, the wages of an employee who does not reside in New York State but works within and outside the state are generally required to be allocated, for purposes of determining income subject to tax by New York ("New York source income"), based on the fraction determined by dividing the employee's days worked in New York by the total number of days worked during the year (see N.Y. Tax Law § 631; 20 NYCRR § 132.18). If the compensation includible in the employee's income for a year is attributable in part to compensation for services performed in an earlier year or over a period of years, computation of the portion of the nonresident's income for the year which is New York source income is more complex.

In the *Adams* case, the petitioner was a nonresident of New York during the years at issue (2016 through 2018). He received from his employer in each of those years, in addition to regular wages, cash bonuses, income from restricted share units (RSUs), and amounts attributable to dividends paid on stock of his employer, all as reported to Adams on IRS Form W-2. Following an audit, the Division of Taxation of New York asserted adjustments to his New York source income based on changes to the allocation of the three categories of income, each as discussed below.

Bonuses. The notice of deficiency from the Division asserted that each cash bonus should be sourced based on the New York workdays in the year preceding the year of payment, based on the Division auditors' understanding from a bonus plan of the employer that the amount of the bonus was determined based on the prior year's performance. Adams asserted that his bonuses were not paid under the bonus plan on which the auditors had relied, and that the bonuses were entirely discretionary and were correctly allocated by Adams based on workdays in New York in the year of payment. The Division ultimately conceded that the bonus income was properly allocated on Adams' returns. Accordingly, the only allocation issues addressed by the Administrative Law Judge in the determination were with respect to income from the RSUs and the dividend-related amounts as reported on Adams' Forms W-2.

RSUs and related dividend rights. Each RSU was a right from Adams' employer to receive one share of common stock of the employer upon vesting. The RSUs vested ratably over five years beginning on the

first anniversary of the date of grant. In addition to the Restricted Share Unit Agreement under which Adams was granted RSUs, a Restricted Share Unit Deferred Compensation Plan (RSU DC Plan) permitted a grantee of RSUs to elect, in the words of the ALJ determination, to "defer receipt of his or her restricted stock units." The dividends reported on the Forms W-2 were, according to Adams' testimony, paid under the RSU DC Plan, with respect to RSUs that had substantially vested. Income from the vesting of RSUs was allocated on Adams' returns based on his New York workdays in the year of vesting.

The Division made adjustments that sourced the income from the RSUs by reference to Adams' workdays from the date of grant to the date of vesting, based on its regulation (20 NYCRR § 132.24) which applies to stock options, stock appreciation rights, and restricted stock. The regulation generally requires the sourcing of income from stock options based on workdays during the period from the date of grant of a stock option to the date the option becomes exercisable, and of income from restricted stock based on the period from the date of receipt of the restricted shares to the date of vesting.

The grant of RSUs, which are generally unfunded and unsecured promises to pay, is different from the grant of actual shares of stock, and stock grants and RSU grants are subject to different Federal tax rules -- the compensatory grant of shares, but not the grant of RSUs, being generally considered a transfer of property under IRC § 83. RSUs are also not stock options or stock appreciation rights as those terms are generally understood for Federal income tax purposes.

It is not apparent from the determination that either Adams, who appeared pro se at the hearing, or the Division alerted the ALJ to these distinctions. Adams asserted that the allocation of RSU based on workdays in the year of receipt was a more equitable allocation method, but the ALJ did not perceive any justification for this assertion. The determination concluded that "restricted stock units clearly fall within the ambit of the regulation," and upheld the Division's adjustment in respect of RSU income based on its regulation with respect to other forms of equity-based compensation.

Dividend income. None of the dividend income reported on the Forms W-2 was treated by Adams as New York source income. His position at the hearing was that the treatment on his returns was correct because the dividend income reported on the Forms W-2 was not attributable to a trade, business or profession carried on in New York, "because the common stock that triggered these dividends had long since vested." The Division disagreed, viewing this dividend income as part of Adams' compensation package, and treated the dividend income reported on each Form W-2 as New York source income based on Adams' New York workdays in the year the dividend income was reported to him.

The general counsel of the employer testified at the hearing, and (per the determination) "corroborated that the dividend income at issue stemmed from restricted stock that had vested." In apparent reliance on this testimony, the court concluded that the dividend income reported on the Forms W-2 was not income earned as a result of a business, trade or profession carried on in New York, and, citing other authority consistent with the general rule that income attributable to intangible personal property of a nonresident not used in a trade or business is not New York source income (Tax Law § 631(b)(2)), concluded that the dividend income was not includible in Adams' New York source income.

Observations

In respect of the RSUs, the ALJ's observation that RSUs are, like (compensatory) stock options and restricted stock, "a form of equity-based compensation," is clearly correct. Taking that into account, the conclusion that the sourcing of income from RSUs should be determined in the same manner as with respect to income from stock options and restricted stock seems sensible notwithstanding the lack of clarity as to whether the regulation cited for that result (or the statutory provision authorizing that regulation) is applicable to RSUs.

In respect of the dividend income reported on Forms W-2, the determination does not discuss the apparent inconsistency between the Federal tax reporting and the assertions made that this dividend income was paid with respect to shares of stock. To the extent Adams received dividends paid on shares of stock in which he had vested, such dividends should have been reported, generally, on IRS Form 1099, not Form W-2. Conversely, it seems plausible that this dividend income reported on Forms W-2 was paid, instead, in satisfaction of a contractual right to payments from the employer equal in amount to the dividends paid on outstanding shares of stock corresponding to the quantity of vested RSUs of Adams, in which case the result reached by the ALJ on this issue seems surprising since such payments should be characterized as additional compensation allocable under rules referenced above.

Considering the complexity of the provisions as well as the apparent lack of New York authority on RSUs, it is not surprising that the ALJ struggled to determine the correct tax treatment of the various payments. It is likely that such difficult issues will continue to come up in the future.

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