In the matter of:

Contact:  

FINAL RULING NO. 2008-39
June 27, 2008

Individual income tax refund adjustment for the tax year ended December 31, 2005

FINAL RULING

The Kentucky Department of Revenue ("DOR") has adjusted the taxpayers' refund request for the taxable year 2005 from $ to $. The following table provides a breakdown of the amount of the requested refund and the amount of refund that was adjusted by the Department of Revenue.

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Requested refund</th>
<th>Refund received</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

BACKGROUND INFORMATION

was a resident of Kentucky until he retired and moved to in 2004. During at least a portion of the time lived in Kentucky, he was employed by . In 2005, exercised stock options he received while living and working in Kentucky. An issue is whether correctly included the stock option income in 's W-2 Wage and Tax Statement for 2005 as income taxable to Kentucky. asserts in his protest that no income was realized while he was a
resident of Kentucky and he is therefore entitled to a refund of the entire amount of Kentucky state income tax withheld.

[Redacted's] protest was received by the Office of Protest Resolution on [redacted], 2008. A letter acknowledging the protest and requesting additional information was sent to the taxpayers on [redacted], 2008. When no response was received from the taxpayers, a second letter was sent on [redacted], 2008. Both letters advised the taxpayers of their right to request a conference pursuant to KRS 131.110(2). Additionally, both letters informed the taxpayers that if a response was not received, the Department of Revenue would issue a final ruling in accordance with KRS 131.110. As of this date, there has been no receipt of correspondence or other evidence of the taxpayers' desire to pursue their protest. Accordingly, this final ruling is being issued.

INCLUSION OF STOCK OPTIONS IN INCOME

The determination of income subject to Kentucky income tax begins with adjusted gross income for Federal income tax purposes (see KRS 141.010). The Federal income tax treatment of employee stock options is very clear. Employee stock options fall into two general categories: (1) statutory stock options which enjoy special tax benefits to the employee as provided in specific provisions of the Internal Revenue Code, and (2) nonstatutory stock options which are subject to tax under general principles of Federal income taxation set forth in Treasury regulations. Statutory options have been subject to varying provisions and have been referred to in the Internal Revenue Code from time to time as “restricted” stock options, “qualified” stock options and “incentive” stock options. Options are generally conditioned on the employee completing a specified period of employment. At the end of that period, the options become nonforfeitable and exercisable, which is usually called “vesting.” The options remain vested until they expire or are exercised. In the case of both statutory and nonstatutory options, there are normally no tax consequences to the employer or employee upon the grant or vesting of the options. On the exercise of a nonstatutory option, the employee will realize and recognize ordinary income treated as compensation for services rendered equal to the difference between the fair market value of the stock received and the option price paid. By contrast, on the exercise of a statutory option the employee will have no recognition of income.

Because [redacted] has included the stock option income in Kentucky state wages on [redacted]'s 2005 W-2 Statement, and because the taxpayers have presented no evidence to the contrary, it is assumed that the stock options in question fall into the category of nonstatutory options.
LAW

Nonresidents are taxed on all income sourced in Kentucky. 103 KAR 17:060, Section 4. Although the taxpayer was living in another state at the time he exercised those options, the income was sourced within Kentucky and was taxable. A stock option transaction is not the purchase of a proprietary interest in a corporation, but an arrangement to transfer property to an employee in recognition of their services to the company and therefore is taxable as compensation. Because the stock options were granted as compensation for services rendered in Kentucky, gain from the exercise of the stock options constituted Kentucky source income even though the taxpayers no longer resided in Kentucky at the time the options were exercised. The stock options were earned while [redacted] was a resident of Kentucky and his former employer has rightfully included the stock option income on the W-2 for 2005 as income taxable to Kentucky.

Pursuant to Treasury Regulation Section 1.83-7 and as concluded in Marchlin v Township of Mt. Lebanon, 560 Pa. 453, 746 A.2d 566 (2000), 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 [redacted] to realize and report the wage income attributable to the company stock options is [redacted] 2005, the date the options were exercised.

CONCLUSION

After reviewing the protest and the applicable statutes, it is the position of the Kentucky Department of Revenue that the refund issued to the taxpayers in the amount of [redacted] was the correct refund, and that the balance of their refund request was properly disallowed. This is a final ruling of the Kentucky Department of Revenue.

APPEAL

You may appeal this final ruling to the Kentucky Board of Tax Appeals pursuant to the provisions of KRS 131.110, KRS 131.340-131.365, 103 KAR 1:010 and 802 KAR 1:010. If you decide to appeal this final ruling, your petition of appeal must be filed at the principal office of the Kentucky Board of Tax Appeals, 128 Brighton Park Boulevard, Frankfort, Kentucky 40602-2120, within thirty (30) days from the date of this final ruling. The rules of the Kentucky Board of Tax Appeals, which are set forth in 802 KAR 1:010, require that the petition of appeal must:

1. Be filed in quintuplicate;
2. Contain a brief statement of the law and facts in issue;
3. Contain the petitioner’s or appellant’s position as to the law and facts; and
4. Include a copy of this final ruling with each copy of the petition of appeal.

The petition of appeal must be in writing and signed by the petitioner or appellant. Filings by facsimile or other electronic means shall not be accepted.

Proceedings before the Kentucky Board of Tax Appeals are conducted in accordance with 103 KAR 1:010, 802 KAR 1:010 and KRS 131.340-131.365 and KRS Chapter 13B. Formal hearings are held by the Board concerning the tax appeals before it, with all testimony and proceedings officially reported. Legal representation of parties to appeals before the Board is governed by the following rules set forth in Section 2 (3) of 802 KAR 1:010:

1. An individual may represent himself in hearings before the Board;
2. An individual who is not an attorney may not represent any other individual, corporation, trust, estate, or partnership before the Board; and
3. An attorney who is not licensed to practice in Kentucky may practice before the Board if he complies with Rule 3.030(2) of the Rules of the Kentucky Supreme Court.

You will be notified by the Clerk of the Board of the date and time set for any hearing.

Sincerely,
Finance and Administration Cabinet

[Signature]
Jason Snyder
Executive Director
Office of Legal Services

CERTIFIED MAIL
RETURN RECEIPT REQUESTED