

ARIZONA DEPARTMENT OF REVENUE

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ARIZONA INDIVIDUAL INCOME TAX RULING ITR 02-5

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ISSUE:

Arizona individual income tax treatment of stock options when there is a change in residency.

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 43-1001 provides that Arizona gross income of a resident individual means the individual's federal adjusted gross income for the taxable year computed pursuant to the internal revenue code.

A.R.S. § 43-1091 provides that Arizona gross income of nonresidents includes only that portion of federal adjusted gross income which represents income from sources within Arizona.

A.R.S. § 43-1092 provides that income from stocks, bonds, notes or other intangible personal property is not income from sources within the state unless the property has acquired a business situs within the state.

Internal Revenue Code (IRC) § 83 addresses the federal income tax treatment of property transferred in connection with performance of services.

IRC § 421 provides the general rules for federal taxation of stock options.

IRC § 422 addresses the federal income tax treatment of incentive stock options.

IRC § 423 addresses the federal income tax treatment of employee stock purchase plans.

IRC § 424 provides definitions and special rules for federal taxation of statutory stock options.

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DISCUSSION:

An employee stock option is the right granted by a corporation to purchase the corporation's stock at a specified price during a specified period. Stock option plans that meet the requirements of IRC §§ 421 through 424 are referred to as statutory stock options. Statutory stock options consist of incentive stock options and employee stock purchase plans. All other stock options are referred to as nonstatutory stock options.

Nonstatutory Stock Options

For federal income tax purposes, a taxpayer will generally recognize compensation for services performed upon the exercise of a nonstatutory stock option. This income is treated as ordinary income. The taxable ordinary income is the difference between the fair market value of the stock on the exercise date and the option price.

Incentive Stock Options

For federal income tax purposes, a taxpayer does not recognize any income when an incentive stock option is granted or when the option is exercised. Income is recognized only when the stock is sold. The nature of the income depends on whether the stock is disposed of in a disqualifying disposition or in a qualifying disposition.

A disqualifying disposition occurs when the stock is sold before the holding period requirements of IRC § 422 are met. If the holding period requirements are not met, the difference between the fair market value of the stock on the exercise date (or the sale price of the stock if lower) and the option price is considered to be compensation for services performed. This income is taxable as ordinary income. Any increase between the stock's fair market value on the sale date and the exercise date is a capital gain.

A qualifying disposition occurs when the stock is sold after the holding period requirements are met. If the holding period requirements are met, the taxpayer will recognize capital gain or loss from the sale.

Employee Stock Purchase Plans

For federal income tax purposes, a taxpayer does not recognize any income when an option is granted or exercised under an employee stock purchase plan. Income is recognized only when the stock is sold. The nature of the income depends on whether the stock is disposed of in a disqualifying disposition or a qualifying disposition.

A disqualifying disposition occurs when the stock is sold before the holding period requirements of IRC § 423 are met. If the holding period requirements are not met, the difference between the fair market value of the stock on the exercise date and the option price is ordinary income (compensation). The basis in the stock is increased by

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this ordinary income. Any difference between the increased basis and the selling price is capital gain.

If the holding period requirements are met (qualifying disposition), the taxpayer recognizes ordinary income (compensation) up to the amount by which the stock's fair market value on the date the option was granted exceeded the option price. Any excess gain is capital gain.

RULING:

Nonstatutory Stock Options

Arizona Resident - Taxpayer Moves Into Arizona

If a taxpayer is granted a nonstatutory stock option while a nonresident of Arizona and later exercises the option while an Arizona resident, the income included in the taxpayer's federal adjusted gross income is subject to Arizona income tax because the taxpayer is an Arizona resident when the income is recognized.

Arizona Nonresident - Taxpayer Moves Out of Arizona

If a taxpayer is granted a nonstatutory stock option while an Arizona resident and later exercises the option while a nonresident, the income recognized is compensation for services. The income is subject to Arizona income tax to the extent the services were performed in Arizona between the grant date to the exercise date.*

Incentive Stock Options

Arizona Resident - Taxpayer Moves Into Arizona

If a taxpayer exercises an incentive stock option while a nonresident of Arizona and later sells the stock in a disqualifying disposition while an Arizona resident, the resulting ordinary income (compensation) and the resulting capital gain, if any, are subject to Arizona income tax because the taxpayer is an Arizona resident when the stock is sold. Similarly, if the taxpayer sells the stock in a qualifying disposition, the capital gain is subject to Arizona income tax.

Arizona Nonresident - Taxpayer Moves Out of Arizona

If a taxpayer exercises an incentive stock option granted in connection with services performed in Arizona and disposes of the stock in a disqualifying disposition while a nonresident, the income (compensation) is subject to Arizona income tax to the extent the services were performed in Arizona between the grant date and the exercise date.* Any gain resulting from the sale of the stock is income from the sale of intangible personal property. Income from the sale of intangible personal property by a

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nonresident is not subject to Arizona income tax unless the stock has acquired a business situs within the state.**

If a taxpayer exercises an incentive stock option granted in connection with services performed in Arizona and disposes of the stock in a qualifying disposition while a nonresident, the resulting capital gain is income from the sale of intangible personal property. Income received by a nonresident from a qualifying disposition of incentive option stock is not subject to Arizona income tax unless the property has acquired a business situs within Arizona.**

Employee Stock Purchase Plans

Arizona Resident - Taxpayer Moves Into Arizona

If a taxpayer exercises an option under an employee stock purchase plan while a nonresident of Arizona and later sells the stock in either a disqualifying disposition or a qualifying disposition while an Arizona resident, the resulting ordinary income (compensation) and the resulting capital gain, if any, are subject to Arizona income tax because the taxpayer is an Arizona resident when the stock is sold.

Arizona Nonresident - Taxpayer Moves Out of Arizona

If a taxpayer exercises an option under an employee stock purchase plan while an Arizona resident and later sells the stock in either a disqualifying disposition or a qualifying disposition while a nonresident, the resulting ordinary income (compensation) is subject to Arizona income tax to the extent the services were performed in Arizona between the grant date and the exercise date.* Any gain resulting from the sale of the stock is income from the sale of intangible personal property. Income from the sale of intangible personal property by a nonresident is not subject to Arizona income tax unless the property has acquired a business situs within Arizona.**

Mark W. Killian, Director

Signed: October 21, 2002

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as

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well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.

* See Appendix

** See Appendix

**APPENDIX
TO
ARIZONA INDIVIDUAL INCOME TAX RULING
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Summary of Arizona Income Tax Treatment of Stock Options

Type of Stock Option	If taxpayer is an Arizona resident	If taxpayer is an Arizona nonresident
Nonstatutory Stock Option	on the date taxpayer exercises the option: <ul style="list-style-type: none"> • Wage income is taxable by Arizona. • Possible other state tax credit. 	on the date taxpayer exercises the option: <ul style="list-style-type: none"> • Wage income is taxable by Arizona to the extent taxpayer performed services in Arizona from the grant date to the exercise date.* • Possible other state tax credit.
Incentive Stock Option	on the date taxpayer sells the stock in a disqualifying disposition at a gain: <ul style="list-style-type: none"> • Wage income and capital gain (if any) are taxable by Arizona. • Possible other state tax credit. 	on the date taxpayer sells the stock in a disqualifying disposition at a gain: <ul style="list-style-type: none"> • Wage income is taxable by Arizona to the extent taxpayer performed services in Arizona from the grant date to the exercise date.* • Possible other state tax credit. • Capital gain (if any) is not taxable by Arizona.**
	on the date taxpayer sells the stock in a qualifying disposition at a gain: <ul style="list-style-type: none"> • Capital gain is taxable by Arizona. 	on the date taxpayer sells the stock in a qualifying disposition at a gain: <ul style="list-style-type: none"> • Capital gain is not taxable by Arizona.**
Employee Stock Purchase Plan	on the date taxpayer sells the stock in a disqualifying or qualifying disposition at a gain: <ul style="list-style-type: none"> • Wage income and capital gain are taxable by Arizona. • Possible other state tax credit. 	on the date taxpayer sells the stock in a disqualifying or qualifying disposition at a gain: <ul style="list-style-type: none"> • Wage income is taxable by Arizona to the extent taxpayer performed services in Arizona from the grant date to the exercise date.* • Possible other state tax credit. • Capital gain (if any) is not taxable by Arizona.**

APPENDIX

(Continued)

* If a taxpayer performed services for the corporation granting the option entirely within Arizona but recognizes income from the option while a nonresident, the income included in the taxpayer's federal adjusted gross income has a source in Arizona where the services were performed and is subject to Arizona income tax.

If a taxpayer performed services for the corporation granting the option both within and outside of Arizona and recognizes income from the option while a nonresident, the taxpayer must allocate to Arizona that portion of the income attributable to services performed in Arizona. The allocation is based on the total amount of time the taxpayer performed services in Arizona from the grant date to the exercise date (or the date employment ended, if earlier). The allocation ratio is:

$$\frac{\text{Arizona workdays from grant date to exercise date}}{\text{Total workdays from grant date to exercise date}}$$

$$\text{Income taxable by Arizona} = \text{Total stock option income} \times \text{Allocation ratio}$$

** Arizona Administrative Code R15-2C-602 addresses a nonresident individual's income from intangible personal property and the business situs of intangible personal property.