STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
LAWRENCE G. RAWL	:	DETERMINATION
	:	DTA NO. 813892
for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law and New York City Nonresident Earnings Tax under the New York City Administrative Code for the Years 1989, 1990, and 1991.	:	

Petitioner, Lawrence G. Rawl, c/o Hodgson, Russ, et al., 1800 One M & T Plaza, Buffalo, New York 14203-2391, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law and New York City nonresident earnings tax[1] under the New York City Administrative Code for the years 1989, 1990, and 1991.

A hearing was commenced before Frank W. Barrie, Administrative Law Judge, at the office of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on December 16, 1997 at 10:00 A.M., continued at the same location on December 17, 1997 at 9:00 A.M., and continued to conclusion at the same location on January 21, 1998 at 9:15 A.M., with all briefs to be submitted by July 1, 1998, which date began the six-month period for the issuance of this determination. Petitioner appeared by Hodgson, Russ, Andrews, Woods & Goodyear, LLP (Paul

[1] It is the New York City nonresident earnings tax at issue in this matter not the New York City personal income tax which was incorrectly referenced in earlier documents. During the years at issue, the tax rate for New York City nonresident earnings tax on wages was .45%. In contrast, the tax rate for New York City personal income tax was substantially higher, $675.00 plus 4.3% on excess over $25,000.00 for the years at issue.

R. Comeau, Esq., and Michel P. Cassier, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Kenneth J. Schultz, Esq., of counsel).

ISSUES

I. Whether the attendance of petitioner, who was the chairman and chief executive officer of Exxon Corporation, at meetings of boards of directors for outside corporations on certain days during 1989 and 1990 should be treated as workdays on behalf of Exxon Corporation.

II. Whether certain days spent by petitioner in Colorado and Mexico during 1990 were incorrectly treated by the Division of Taxation as personal vacation days rather than business days on behalf of Exxon Corporation.

III. Whether the grant to exercise allocation period methodology [i.e., the application of a fraction consisting of a numerator representing days worked in New York and a denominator consisting of total days worked during a period of multiple years, running from the date of grant until (i) the date of exercise of stock options and (ii) the date of maturity of earnings bonus units] used by the Division of Taxation to allocate a portion of the compensation received by petitioner, a nonresident of New York, from his exercise of stock options and the maturing of earnings bonus units, was a reversal of the Division of Taxation's prior policy, of utilizing a year of exercise methodology, without public notice so that the use of the grant to exercise allocation period methodology was arbitrary and capricious, or whether the Division of Taxation's use of the grant to exercise allocation period methodology was mandated by the 1986 Court of Appeals decision in ***Michaelsen v. New York State Tax Commission***, 67 NY2d 579, 505 NYS2d 585.

IV. Whether the Division of Taxation violated petitioner's rights against selective enforcement by changing its method of allocating a nonresident's compensation from the exercise of stock options and earnings bonus units to New York, from an analysis based upon

workdays in the year of exercise to workdays during the period from the date of grant to the date of exercise, in order to target and punish petitioner, who was the chairman and chief executive officer of Exxon Corporation when the corporation moved its corporate headquarters from New York City to Dallas, Texas.

V. Whether the Division of Taxation is precluded from allocating petitioner's compensation from the exercise of stock options and earnings bonus units based upon a grant to exercise allocation period methodology, as a result of its failure to adopt a rule, regulation, or guidelines in compliance with the State Administrative Procedures Act and the New York State Constitution, so that it improperly imposed a retroactive rule change on petitioner in an *ad hoc* and arbitrary manner.

VI. Whether consents to extend the period of limitations for assessment of 1989 and 1990 income tax against petitioner, which were executed on behalf of petitioner by a prior representative, were ineffective because the power of attorney appointing such representative was defective due to the failure of the prior representative to sign the notice of appearance section in the power of attorney.

FINDINGS OF FACT

1. In 1993, petitioner, Lawrence Rawl[2], retired from Exxon Corporation ("Exxon"), one of the top five industrial companies in the world, after a career with this global corporation which spanned 41 years. During the years at issue and at the time of his retirement, Mr. Rawl was the chairman and chief executive officer of a company with approximately 95,000 employees, operations in all 50 states and 80 countries, worldwide sales of over $100 billion, and earnings of approximately $5 billion. As Exxon's chairman and chief executive officer, petitioner was part of the corporation's management committee, which included five other individuals, Exxon's president and four senior vice presidents. Exxon never had an employment agreement with petitioner, and his employment status was at the will of the corporation.

2. Exxon's corporate headquarters, with approximately 350 to 400 employees, were located in New York City until August 23, 1990 when they were moved to a Dallas suburb. As Exxon's chairman and chief executive officer, Mr. Rawl spent a substantial portion of his total workdays in Exxon's midtown Manhattan headquarters during 1989 and 1990, but he also spent a significant amount of time traveling outside of New York on Exxon business. Upon the relocation of corporate headquarters to Texas, petitioner reported no New York workdays, which has not been contested by the Division of Taxation ("Division").

3. Petitioner was responsible for the broad spectrum of business activities conducted by Exxon, namely the worldwide exploration, production, and refining of crude oil and the marketing of crude oil petroleum products, as well as chemical businesses that use petroleum feedstock, and businesses involving power generation and the production of coal minerals. In

[2] Mr. Rawl did not appear and testify at the formal hearing held in this matter. The findings of fact in this determination concerning his career with Exxon and the preparation of his New York income tax returns at issue were based upon a review of documents including two affidavits of Mr. Rawl and the testimony of David L. Hinshaw, Exxon's general tax counsel.

the words of David L. Hinshaw, Exxon's general tax counsel, petitioner didn't just worry "about oil coming out of the ground and how it got to the refinery" (tr., p. 394). In addition, according to Mr. Hinshaw:

> [Mr. Rawl] had to interface with all the issues facing a corporation: public affairs, legal, environmental. Public opinion was important. Interrelating with other business leaders was an important part of his role as the chief spokesman for the company (tr., p. 394).

Petitioner's New York Income Tax Returns

4. For each of the years at issue, petitioner and his wife, Betty E. Rawl, timely filed nonresident income tax returns (Forms IT-203). During the years at issue, up to Exxon's relocation of its corporate headquarters to Texas on August 23, 1990, petitioner was a resident of Greenwich, Connecticut. Subsequent to the relocation of Exxon headquarters, petitioner became a resident of Irving, Texas. The Division of Taxation ("Division") has not contested petitioner's status as a nonresident of New York during the years at issue.

5. Petitioner reported (i) 1989 New York wages of $1,192,200.00, which represented 69.87% of his 1989 Exxon wages for federal purposes of $1,706,214.00; (ii) 1990 New York wages of $568,339.00, which represented 50.59%[3] of his 1990 Exxon wages for federal purposes of $1,123,467.00 earned during the period running from January 1, 1990 until August 23, 1990, the day on which Exxon headquarters were relocated to Texas, and no part of his 1990 Exxon wages for federal purposes of $973,126.00 earned during the period running from August 23, 1990 until December 31, 1990; and (iii) no part of his 1991 Exxon wages for federal purposes of $9,567,725.00 as New York wages.

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[3] In comparison with petitioner's allocation percentages of 69.87% for 1989 and 50.59% for the partial period during 1990, for 1986 and 1987, petitioner's allocation percentages were 78.11% and 63.49%, respectively.

6. Petitioner's tax returns indicated that the percentages for allocating his Exxon wages to New York were computed by comparing his New York workdays for Exxon to his total workdays for Exxon. For 1989, petitioner calculated his total Exxon workdays of 239 by subtracting total nonworking days of 126 from total days in 1989 of 365 (365 less 126 equals 239). Total nonworking days in 1989 of 126 was determined by adding 85 Saturdays and Sundays (out of the 102 Saturdays and Sundays in 1989), plus 11 holidays, and 30 vacation days (85 plus 11 plus 30 equals 126). Petitioner subtracted 72 Exxon workdays outside New York from total Exxon workdays of 239 to calculate 167 Exxon workdays in New York. He then allocated his wages from Exxon to New York by multiplying his Exxon wages of $1,706,214.00 reported for federal purposes by a fraction with a numerator of 167, representing his Exxon workdays in New York, and a denominator of 239, representing his total Exxon workdays in 1989. Expressed in percentage form, this fraction equals 69.87% as noted in Finding of Fact "5".

For 1990, petitioner calculated his total Exxon workdays of 170 during the period January 1, 1990 until August 23, 1990, the day on which Exxon relocated its corporate headquarters to Texas, by subtracting total nonworking days of 68 from total days in 1990, up to the corporate relocation to Texas on August 23, 1990, of 238[4] days (238 less 68 equals 170). Total nonworking days of 68 was determined by adding 50 Saturdays and Sundays (out of the 62 Saturdays and Sundays in 1989 during the period January 1, 1990 until August 23, 1990), plus 3 holidays, and 15 vacation days (50 plus 3 plus 15 equals 68). Petitioner then subtracted 84 Exxon workdays outside New York from total Exxon workdays of 170 to calculate 86 Exxon

[4] There are, in fact, 234 days in the period January 1, 1990 until August 23, 1990 when Exxon's corporate headquarters were relocated from New York to Texas. There is no explanation in the record why petitioner used 238 days in the above calculation. Furthermore, on his 1990 tax return, petitioner indicated that on August 20, 1990 he "moved out of New York State and received no income from New York State sources during [his] nonresident period."

workdays in New York. He then allocated his wages from Exxon during the period January 1, 1990 until August 23, 1990 to New York by multiplying his Exxon wages of $1,123,467.00 reported for federal purposes by a fraction with a numerator of 86, representing his Exxon workdays in New York, and a denominator of 170, representing his total Exxon workdays in the period January 1, 1990 until August 23, 1990. Expressed in percentage form, this fraction equals 50.59% as noted in Finding of Fact "5".

For the period August 23, 1990 to December 31, 1990 and for 1991, petitioner allocated no part of his Exxon wages of $973,126.00 and of $9,567,725.00, respectively, to New York. Petitioner reported no Exxon workdays in New York during these two periods.

7. At the time petitioner's 1991 New York nonresident income tax return was prepared in 1992, his tax advisors researched the proper treatment for New York tax purposes of his income from the stock option and earnings bonus units which was included in the amount reported as Exxon wages for federal tax purposes. David L. Hinshaw, an assistant general tax counsel at Exxon at the time, who was responsible for tax aspects of executive compensation plans at Exxon, including Mr. Rawl's, consulted with various tax experts and conducted his own research. He concluded that New York's rule governing the allocation of stock option income by nonresidents was that such income should be allocated to New York based on the taxpayer's workday ratio in the year of exercise. Consequently, since petitioner had no Exxon workdays in New York in 1991, the year of exercise, no part of his income from stock options and earnings bonus units was allocable to New York.

The Audit

8. Frances Glicksman, the Division's auditor, performed a detailed analysis of petitioner's calculation of the percentages for allocating his Exxon wages to New York for 1989

and 1990. As noted in Finding of Fact "6", according to petitioner, for 1989 he had 167 Exxon workdays in New York and 72 Exxon workdays outside of New York out of total Exxon workdays of 239 resulting in an allocation percentage of 69.87%. The auditor recalculated petitioner's allocation percentage for 1989 after determining that petitioner had 165 Exxon workdays in New York out of total Exxon workdays of 231. The auditor disallowed eight days, as Exxon workdays outside of New York, consisting of four days on which petitioner attended meetings of the board of directors of Warner Lambert in Paris, France, i.e., May 26 through May 29, 1989 and of four days on which he attended meetings of the board of directors of Champion International Corp. in Stamford, Connecticut, i.e., February 27, August 17, September 21 and November 16, 1989. To petitioner's advantage, the auditor also decreased petitioner's Exxon workdays in New York by two days, December 4 and 5, 1989, when she determined that he was outside of New York in Washington, D.C. and Houston, Texas, respectively, and should have treated these two days as Exxon workdays outside of New York. Consequently, the auditor reduced petitioner's total Exxon workdays by 8 days, from his claimed 239 days to 231 days, and she also decreased petitioner's Exxon workdays in New York by two days, from his claimed 167 days to 165 days, resulting in an allocation percentage of 71.43%, representing almost a 2% increase of petitioner's reported allocation percentage of 69.87%.

As noted in Finding of Fact "6", according to petitioner, for 1990 he had 86 Exxon workdays in New York and 84 Exxon workdays outside of New York out of total Exxon workdays of 170 during the period January 1, 1990 until August 23, 1990, the day on which Exxon relocated its corporate headquarters to Texas, resulting in an allocation percentage of 50.59%. The auditor recalculated petitioner's allocation percentage for 1990 after determining that petitioner had 89 Exxon workdays in New York and 68 Exxon workdays outside of New

York out of total Exxon workdays during 1990 up to August 23, 1990 of 157. The auditor disallowed 16 days which petitioner claimed were Exxon workdays outside of New York consisting of (i) 7 days on which petitioner attended meetings of the board of directors of Champion International Corp. in Stamford, Connecticut, i.e., January 17 and 18, March 14 and 15, May 17, June 21, and August 16, 1990, (ii) 3 days on which petitioner attended meetings of the board of directors of Warner Lambert in Morristown, New Jersey, i.e., April 24, August 10 and 11, 1990, (iii) 3 days which the auditor categorized as a Mexican fishing trip and as non-business days, i.e., February 16, 17, and 18, 1990, and (iv) 3 days which she categorized as a golf trip to the Denver, Colorado area and as non-business days, i.e., July 6, 7, and 8, 1990. The auditor also increased petitioner's Exxon workdays in New York to 89 consisting of (i) the Fridays before the Mexican fishing trip and Denver golf trip, i.e., February 16, 1990 and July 6, 1990, respectively, and (ii) one day for what the auditor described as a "mathematical error" (tr., p.80). However, the auditor's explanation of the so-called mathematical error was not understandable. According to the auditor's workpaper for 1990, which she numbered 20: "There were 68 Sat & Sun in 238 day year". First, as noted in footnote "2" there are, in fact, 234 days in the period January 1, 1990 until August 23, 1990 when Exxon's corporate headquarters were relocated to Texas. But even if you add four days to this period given the auditor's reference to a 238 day year, there are only 64, not the auditor's 68, Saturdays and Sundays in the period January 1, 1990 until August 27, 1990.

9. As noted in Finding of Fact "5", petitioner allocated no part of his 1991 Exxon wages of $9,567,725.00 to New York. The auditor testified that in comparison with petitioner's Exxon wages in 1989 and 1990 of $1,706,214.00 and $2,096,593.00, respectively, she noted "a big

disparity in [petitioner's] income", and since there was also a change in petitioner's address, the auditor "felt that [the 1991 tax year] should be included in the audit" (tr., p. 72).

10. The auditor ascertained that petitioner in 1991 exercised certain stock options and earnings bonus units which generated compensatory income from Exxon as follows:

Type of compensation	Grant Date	Exercise Date	Amount
Stock Option	November 25, 1985	May 6, 1991	$3,136,561.75
Stock Option	November 24, 1986	May 6, 1991	3,815,312.81
Earnings Bonus Units	November 30, 1988	March 31, 1991	345,000.00
Earnings Bonus Units	November 29, 1989	September 30, 1991	300,000.00
Total			$7,596,874.56

11. Petitioner's remaining Exxon wages for 1991 of $1,970,850.44 ($9,567,725.00 less $7,596,874.56) consisted of an incentive cash bonus of $505,000.00 awarded to petitioner on November 27, 1991 by Exxon and presumably[5] W-2 earnings for 1991 of $1,465,850.44. Since the incentive cash bonus awarded in 1991 was "not related to any years prior to 1991" according to Exxon and was not contested by the Division, and since the auditor, as noted in Finding of Fact "2", accepted petitioner's position that he had no Exxon business days in New York in 1991, the auditor agreed that no part of petitioner's remaining Exxon wages for 1991 of $1,970,850.44 was allocable to New York. However, with regard to petitioner's income of $7,596,874.56 generated by his exercise of stock options and earnings bonus unit in 1991, the

[5] Since petitioner reported no Exxon wages allocable to New York in 1991, no wage and tax statements (W-2 forms) were attached to his 1991 nonresident New York tax return.

auditor determined that $4,525,683.00, representing approximately 60% of such income, was subject to New York State income tax.

12. The auditor prepared a detailed worksheet, which she numbered page 23 of her audit report, on which she calculated the portion of the stock options and earnings bonus units subject to New York State income tax. The auditor utilized a grant to exercise allocation period methodology. She applied against each of the four items of compensation at issue a separately calculated fraction consisting of a numerator representing Exxon workdays in New York and a denominator consisting of total Exxon workdays during a period of multiple years, running from the date of grant until the date of exercise of the stock options and the date of maturity of the earnings bonus units in 1991, as follows:

Type of compensation	Grant Date	Exercise Date	Amount	Allocation fraction	Amount allocated
Stock option	11/25/85	5/6/91	$3,136,561.75	809/1263	$2,009,088.00
Stock option	11/24/86	5/6/91	3,815,312.81	615/1035	2,267,070.00
Earnings bonus units	11/30/88	3/31/91	345,000.00	268/532	173,797.00
Earnings bonus units	11/29/89	9/30/91	300,000.00	104/412	75,728.00
Total					$4,525,683.00

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13. The Division issued three statements of personal income tax audit changes each dated August 25, 1994 against petitioner asserting tax due for 1989, 1990, and 1991 based upon

additional compensation allocable to New York after audit of $26,524.00, $68,531.00, and $4,525,683.00, respectively. The statements showed additional tax liabilities as follows:

	New York State Personal Income Tax	New York City Nonresident earnings tax	Total Liability
1989 corrected tax liability	$96,044.04	$ 5,576.44	$101,620,48
1989 tax previously paid	94,019.00	5,461.00	99,480.00
Additional 1989 tax liability	$ 2,025.04	$ 115.44	$ 2,140.48
1990 corrected tax liability	$50,650.80	$ 2,910.89	$ 53,561.69
1990 tax previously paid	45,416.00	2,446.00	47,862.00
Additional 1990 tax liability	$ 5,234.80	$ 464.89	$ 5,699.69
1991 corrected tax liability	$354,568.68	$20,374.70	$374,943.38
1991 tax previously paid	79.00	0.00	79.00
Additional 1991 tax liability	$354,489.68	$20,374.70	$374,864.38

Each of the three statements of personal income tax audit changes computed interest on the additional tax liabilities asserted due, but did not assert any penalties against petitioner.

14. The Division then issued a Notice of Deficiency dated November 14, 1994 against petitioner asserting tax due plus interest as follows:

Tax Year	Tax Amount Due	Interest Amount Due	Total Due
1989	$ 2,025.04	$ 837.36	$ 2,862.40

1989	115.44	47.73	163.17
1990	5,234.80	1,494.20	6,729.00
1990	464.89	132.70	597.59
1991	354,489.68	63,340.75	417,830.43
1991	20,374.70	3,640.58	24,015.28
Totals	$382,704.55	$ 69,493.32	$452,197.87

15. At the continuation of the hearing on January 21, 1998, the auditor noted that she had prepared a corrected worksheet to account for "an error in the 1991 denominator" pointed out by petitioner's representative (tr., p. 593). As a result, the allocation fractions noted in Finding of Fact "12" were revised and slightly reduced amounts of compensation from the four stock options and earnings bonus units at issue were allocated to New York as follows:

Type of compensation	Grant Date	Exercise Date	Amount	Allocation fraction	Amount allocated
Stock option	11/25/85	5/6/91	$3,136,561.75	809/1267	$2,002,745.00
Stock option	11/24/86	5/6/91	3,815,312.81	615/1039	2,258,342.00
Earnings bonus units	11/30/88	3/31/91	345,000.00	268/534	173,146.00
Earnings bonus units	11/29/89	9/30/91	300,000.00	104/420	74,286.00
Total					$4,508,519.00

The total amount of compensation from the stock options and earnings bonus units allocated to New York in the revised worksheet of $4,508,519.00 was $17,164.00 less than the total amount originally allocated by the auditor of $4,525,683.00, as noted in Finding of Fact "12". The Division revised the statement of personal income tax audit changes for 1991 issued

against petitioner to reflect this reduction in the amount of compensation from the stock options and earning bonus units allocated to New York as follows:

	New York State Personal Income Tax	New York City Nonresident earnings tax	Total Liability
1991 corrected tax liability	$353,219.31	$20,297.47	$373,516.78
1991 tax previously paid	79.00	0.00	79.00
Additional 1991 tax liability	$353,140.31	$20,297.47	$373,437.78

The total additional 1991 tax liability of $373,437.78 represents a reduction of $1,426.60 in the amount asserted due in the original statement of personal income tax audit changes for 1991, noted in Finding of Fact "13" ($374,864.38 less $373,437.78 equals $1,426.60).

` ***Petitioner's Membership on Boards of Directors of Outside Corporations***

16. The auditor did not allow petitioner to claim days on which he attended meetings of the boards of directors of Warner Lambert in Morristown, New Jersey and in Paris, France and of Champion International Corp. in Stamford, Connecticut as Exxon workdays outside New York. According to the auditor, "[T]hese were not Exxon working days" (tr., p.76). From the auditor's perspective, petitioner was not *required* by Exxon to be a director of outside corporations. In contrast, petitioner maintains that serving on outside boards is *not* an Exxon employee's personal business, but rather is a business activity that serves Exxon's business interests.

17. Exxon issued a policy statement dated June 28, 1978 to its employees regarding "directorships in non-affiliated commercial, industrial or financial organizations". Exxon's general policy was:

> [T]o restrict the holding by employees of directorships in non-affiliated commercial, industrial or financial organizations and to prohibit the acceptance by any employee of such a directorship if it would involve a conflict of interest with, or interfere with the complete discharge of the individual's duties to the Corporation.

However, petitioner, as chairman of Exxon's board of directors, along with Exxon's president, were specifically authorized to "accept a limited number of directorships, after review by the Board of Directors". Other Exxon employee directors were authorized to "accept one directorship, after review by the Chairman of the Board [i.e., petitioner], who will consult with the Compensation and Executive Development Committee", and chief executives of Exxon regional and operating organizations were also authorized to "accept one[6] directorship in the geographical area for which the organization is responsible or in the metropolitan area where it maintains its executive offices, after review by the Chairman of the Board . . . who will consult with the Compensation and Executive Development Committee". This policy statement recognized "that there may be circumstances where the holding of [outside directorships] would be in the Corporation's interest: for example, as a way of adding to the perspective of senior executives." All other Exxon employees were:

> generally discouraged from serving as directors of [outside corporations]. However, on the recommendation of the Contact Executive concerned, the Corporation, after review by the Chairman of the Board, who will consult with the Compensation and Executive Development Committee, may make exceptions to this general rule in special circumstances, such as instances where the Corporation's interests would best be served or instances of an employee who may desire to serve as a director of a family-owned company, or for an employee who has firm plans to retire within three years.

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[6] The policy statement on outside directorships further provided that:

> "[i]n special circumstances, more than one such directorship may be accepted by employee Directors other than the Chairman of the Board and the President and by the chief executives of regional and operating organizations if in the judgment of the Chairman of the Board, who will consult with the Compensation and Executive Development Committee, the Corporation's interests would be served thereby."

18. A subsequent policy statement dated November 1991 was issued by Exxon which set forth the same principles with regard to outside directorships as the earlier policy statement dated approximately 13 years earlier, detailed in Finding of Fact "17".

19. Exxon encouraged petitioner, its chairman and chief executive officer, to become an outside director of Champion International Corp. and Warner Lambert in order to broaden his global perspective and to obtain input, in the words of David L. Hinshaw, an Exxon corporate attorney for approximately 25 years who during the years at issue was an assistant general tax counsel for the corporation, "from more than just the people that report up to him in [the Exxon] organization" (tr., p.397). According to Mr. Rawl's affidavit dated December 11, 1997, he "would not have sat on these boards if I had not considered it to be part of my job duties for Exxon." Exxon's corporate jet was at petitioner's disposal for travel to meetings of the boards of directors of Warner Lambert and Champion International Corp.

20. Champion International Corp., which owns over five million acres of property in the United States, is a major supplier of paper and wood products, such as pulp, construction materials, and plywood. Warner Lambert is a global corporation in the health care and personal consumer products and confectionery business. Joseph Williams, Warner Lambert's chairman, in turn, served as an outside director on Exxon's board of directors, which was made up of 4 employee directors including petitioner and 12 outside directors..

21. Petitioner received compensation from Champion International Corp. of $25,718.00 and $6,912.00 for 1989 and 1990, respectively, for serving on its board of directors. None of this income was allocated to New York. Petitioner reported no compensation from Warner Lambert for serving on its board of directors.

Mexican Fishing Trip and Denver Golf Resort Trip

22. The auditor did not allow petitioner to claim the three days of February 16, 17, and 18, 1990, which were a Friday, Saturday, and Sunday, respectively, as Exxon workdays outside New York on the basis that they were not Exxon business days, but rather constituted a fishing trip in Mexico. As noted in Finding of Fact "8", the auditor, in fact, treated the Friday, February 16, 1990 as an Exxon workday in New York on the basis that petitioner had failed to prove that this weekday was an Exxon workday outside of New York.

23. Exxon had significant interest in the stability of the Middle East, which was the source of supply of much of the corporation's crude oil used in its refineries. Exxon had no direct petroleum ownership in many oil-rich countries in the Middle East since its properties had been nationalized by Saudi Arabia, Iran and Iraq. Nonetheless, in the words of Mr. Hinshaw, Exxon "relied heavily on the stability of the petroleum supply from the Middle East because of the influence it has on crude prices" (tr., p. 387). Furthermore, Exxon did have some direct investment interest in petroleum in Yemen as a participant in a joint venture with Hunt Oil.

24. The three day Mexican fishing trip in February, 1990 had been arranged by Ray Hunt, the chief executive officer of Hunt Oil Co., in order for Mr. Rawl and Mr. Hunt to meet privately with a high level governmental official to discuss security matters in the Middle East, which was very timely given the fact that the United States soon would be engaged in a war in the Persian Gulf region against Iraq known as Desert Storm. The fishing aspect of the trip was secondary to these high level discussions. These findings of fact concerning petitioner's Mexican fishing trip were based upon Mr. Hinshaw's testimony. Mr. Hinshaw explained that he had discussed the specifics of the Mexican fishing trip with Mr. Rawl.

25. The auditor also did not allow petitioner to claim the three days of July 6, 7, and 8, 1990, which were a Friday, Saturday, and Sunday, respectively, as Exxon workdays outside New

York on the basis that they were non-business days consisting of a golf trip to the Denver area. During this summer weekend, petitioner attended a meeting of the Independent Producers Association of America at the Castle Pines Golf Course in the Denver area. According to Mr. Rawl's affidavit dated January 19, 1998, "members in the Independent Producers Association of America engage in wildcatting, exploration and drilling of oil wells and reserves in the United States and abroad." Exxon paid for Mr. Rawl's travel expenses to attend this weekend meeting, and petitioner noted in his affidavit that "These contacts and relationships have provided valuable information and business opportunities for Exxon." Further, according to petitioner's affidavit, he "did not play golf during the trip."

Petitioner's Stock Options and Earnings Bonus Units

26. As part of his compensation from Exxon, petitioner received (i) stock options and related stock appreciation rights[7] ("stock options") and (ii) earnings bonus units. David L. Hinshaw, who is currently Exxon's general tax counsel and as noted in Finding of Fact "7" was an Exxon assistant general tax counsel during the years at issue, provided the following concise definition of the stock options that Exxon had provided to petitioner:

> Stock options are the right that is granted by the corporation to an executive to purchase shares of the corporation at a specified price within a program that's defined by time (tr., p.409).

[7] As an alternative to petitioner's exercise of the stock option, he had a "stock appreciation right" pursuant to which he was "entitled to surrender to [Exxon] unexercised this Option . . . and to receive . . . in exchange therefor a settlement equivalent in value to that number of shares of [Exxon's] capital stock having an aggregate value equal to the excess of the value of one share over the option price per share times the number of shares called for by the Option . . . ." Therefore, exercising the stock appreciation rights in lieu of actually purchasing the stock by strictly exercising the option was the economic equivalent of purchasing the stock by the option and then immediately selling it on the open market.

As noted in Finding of Fact "10", Mr. Rawl exercised two stock options and two earnings bonus units in 1991 which generated compensatory income from Exxon in the total amount of $7,596,874.00.

27. The two stock options exercised in 1991 were granted to petitioner by Exxon on November 25, 1985 ("1985 stock option") and November 24, 1986 ("1986 stock option"), respectively, pursuant to an incentive program adopted by Exxon shareholders on May 19, 1983. The 1985 stock option provided petitioner with the option to purchase from Exxon 48,116 shares of its capital stock at a price per share of $53.0625. It became exercisable one year after its date of grant, i.e., November 25, 1986, and included the following provision with regard to its lapsing:

> 3. This Option shall lapse at the earliest of the following times:
> (A) If the Optionee terminates normally, it shall lapse five years thereafter, if the Optionee is then still living.
> (B) If the Optionee terminates otherwise than normally, it shall lapse at the time of termination.
> (C) If the Optionee dies, it shall lapse one year after death.
> (D) In any event, it shall lapse ten years after its date.

28. The 1986 stock option provided petitioner with the option to purchase from Exxon 78,565 shares of its capital stock at a price per share of $69.68750. Like the 1985 stock option it became exercisable one year after its grant, which in this case would be November 24, 1987, and it also included the same provision with regard to its lapsing.

29. In addition to stock options, Exxon granted petitioner a type of employee incentive described as earnings bonus units. Two are at issue, one granted on November 30, 1988 ("1988 earnings bonus unit") and the second on November 29, 1989 ("1989 earnings bonus unit"). Mr. Hinshaw, defined earnings bonus units as follows:

> Earnings bonus units are a form of deferred compensation that are designed to allow the person to receive cash or shares of the corporation equivalent to that cash at a time when the performance of the company achieves a certain level of earnings per share (tr., pp 409-410).

Mr. Hinshaw noted further that earnings bonus units are not exercised by the employee like stock options. According to Mr. Hinshaw:

> [I]t's a set level of units and it matures or expires depending on the performance of the company. It is hoped that as an incentive for people to continue the good performance of the company the earnings per share will reach a certain level to equal the grant, and the grant will become operative and you will receive a payment based on the amount of earnings bonus units you received (tr., p. 414).

30. Petitioner's 1988 earnings bonus units consisted of a grant of 46,000 units with a settlement value of $7.50 per unit, and his 1989 earnings bonus unit consisted of a grant of 40,000 units with the same settlement value of $7.50 per unit. Exxon's earnings per share reached the required level for the 1988 earnings bonus units and the 1989 earnings bonus units to mature in March 1991 and October 1991, respectively. As a result, petitioner received additional employee compensation of $345,000.00 (46,000 units multiplied by $7.50 equals $345,000.00) and $300,000.00 (40,000 units multiplied by $7.50 equals $$300,000.00) for the 1988 and 1989 earnings bonus units, respectively, during 1991.

31. The instruments granting petitioner the earnings bonus units at issue included the following provision with regard to their "provisional" nature:

> The grant of the bonus in earnings bonus units evidenced by this instrument is provisional until cash is paid in settlement hereof. If, while the grant is provisional,
>
> (1) the Grantee terminates but does not terminate normally, or
>
> (2) the Grantee after terminating engages in a detrimental activity,
>
> the grant shall be annulled as of the date of termination, or the date such activity is determined to be detrimental, as the case may be.

32. As noted in Finding of Fact "6", petitioner allocated to New York no portion of his employee compensation received in 1991 from his exercise of the stock options and from the maturity of the earnings bonus units detailed above. Petitioner utilized his Exxon workday ratio for 1991, the year of exercise and maturity, to determine whether any of such compensation was allocable to New York. Since petitioner claimed no Exxon workdays in New York in 1991, no part of such compensation was allocated to New York.

33. Petitioner reported similar income from the exercise of a stock option in 1986 and from the maturity of earnings bonus units in 1987. Petitioner asserts that he allocated such income based upon Exxon workdays in New York during the year of exercise and the year of maturity, and that the Division during audit did not alter his allocation. However, Suresh Bansal, the auditor who conducted the audit of petitioner's 1986 and 1987 tax years, did not look into the issue concerning petitioner's allocation of his compensation from the exercise of the stock option and the maturity of earnings bonus units. Rather, according to the auditor, "The only issue that we looked into was the allocation of salary" (tr., p. 171). Furthermore, a review of petitioner's nonresident income tax returns for 1986 and 1987 shows that petitioner utilized different allocation percentages for salary income and for employee compensation from the exercise of the stock option in 1986 and the maturity of earnings bonus units in 1987. In 1986, petitioner allocated 78.1115% of his salary of $671,913.00 to New York, 78.1115% of a 1986 bonus payment and dividends deemed compensation of $190,234.00 to New York, 70.0422% of a 1983 bonus payment to New York, and 73.3905% of his stock option income to New York. The record does not explain the basis for the different allocation rates. Further, the sum of the preceding amounts does not equal the total amount of wages and salaries reported for 1986 of $1,729,508.00. Rather, the sum of such amounts equals $1,589,954.00, which is an unexplained

$139,554.00 less than the total amount. It is noted that the sum of the amounts shown on two attached Exxon wage and tax statements for 1986 equals $1,719,508.00 ($671,912.67 plus $1,057,594.13). Similarly, in 1987, petitioner allocated 63.4854% of his salary income to New York while allocating 64.7540% of his 1984 earnings bonus units which apparently matured in 1987.

How the Auditor Came to Utilize a Grant to Exercise Rule for Allocation to New York

34. The audit at issue was the first audit in which the auditor, Frances Glicksman, addressed the issue of the allocation to New York of a nonresident's compensation from the exercise of a stock option or from the maturity of earnings bonus units. Mrs. Glicksman in the course of her audit, in 1993, became aware of the grant to exercise allocation period methodology. The auditor testified that she was not aware of "any other methodology relating to the allocation of stock option income other than the [grant to exercise allocation period] methodology" (tr., p.100). At a staff meeting during 1993, the auditor heard a colleague discuss his use of the grant to exercise allocation period methodology for allocating a nonresident's stock option income to New York. The auditor testified that she researched the issue of forfeiture and not the year of exercise as a methodology for allocation because petitioner's representative during the initial stages of the audit, Helmer W. Arizmendy,[8] raised the first and not the latter issue. However, at the later stages of the audit, petitioner's current representative raised the issue that the proper methodology for allocating petitioner's compensation from the exercise of stock options and the maturity of earnings bonus units was Exxon days worked in New York compared to total Exxon workdays during the year of exercise or of maturity. The auditor reviewed certain decisions of the State Tax Commission provided by petitioner's current representative, but at the

[8] Mr. Arizmendy did not appear and testify at the formal hearing in this matter.

direction of her supervisor, Steven Helfant, the auditor maintained her position that a grant to exercise or maturity period should be used to allocate the income at issue. According to the auditor, the importance of the decisions of the State Tax Commission was the conclusion that a nonresident's income from stock options could be allocated to New York and was not investment income which could not be allocated.

35. Steven Helfant instructed the auditor to use the grant to exercise period for allocating the stock options and earnings bonus units to New York based upon a memorandum he had received from John Coniglio of field audit management. Mr. Coniglio's memorandum dated November 3, 1992 noted that the Court of Appeals in its 1986 decision in ***Michaelsen v. New York State Tax Commission***, 67 NY2d 579, 505 NYS2d 585:

> reasoned that compensation is measured by the appreciation in the value of the stock between the grant and exercise dates, that period is considered the compensable period of the option. Therefore, a nonresident would allocate his or her compensation for this period by the allocation in effect between the grant and exercise dates.

36. Mr. Coniglio's position on the use of the grant to exercise period mirrored the opinion of Elizabeth McNulty, an associate counsel in the Division's former Bureau of Law/Litigation, in her memorandum dated July 25, 1989 on behalf of William F. Collins, the Division's former Deputy Commissioner and Counsel to Gabriel DiCerbo, the former director of the Taxpayer Services Division. Ms. McNulty noted as follows:

> In accordance with ***Michaelson*** [sic], the gain realized upon *exercise* of a statutory option is the appropriate measure of the compensation element; any further gain realized upon subsequent sale of the stock is investment income not taxable by New York. Thus, gain *recognized* for federal purposes at the time of sale of the stock is limited for State purposes to the gain *realized* but unrecognized at the prior time of option exercise.
>
> Given that gain realized upon exercise of a statutory option is compensation taxable by New York, it is then necessary to allocate this gain within and without the State, if a nonresident works both within and without New York, based upon

> the New York employment which the option was intended to compensate. The option price of a statutory option must, by definition, equal or closely correspond to the fair market value of the stock at, generally, the date of *grant*. Any gain upon exercise, then, amounts to the appreciation in value from the date of grant to the date of exercise. It seems logical that since the gain accruing over the period from grant to exercise is considered compensation under ***Michaelson*** [sic], the entire period should be considered the intended compensable period of the option. The entire period should accordingly be taken into account for State purposes in determining allocation of the gain to New York. Where the period spans a number of years, the average New York allocation percentage of those years with respect to the employment related to the option should be used to determine the New York allocation of the gain. [Emphasis in original.]

37. The memorandum dated July 25, 1989 from the Division's former Bureau of Law/Litigation to the director of the Taxpayer Services Division, as a final point, also noted that "A TSB-M on the subject is due out shortly." However, TSB-M-95-(3)I, a memorandum prepared by the Technical Services Bureau of the Taxpayer Services Division, to provide "guidance on the New York tax treatment of stock options, restricted stock and stock appreciation rights received by nonresidents . . . who are or were employed in New York State", was not issued until November 21, 1995. After providing a summary of the 1986 Court of Appeals decision in ***Michaelsen***, this 1995 memorandum described how a nonresident's employee compensation from the exercise of stock options should be allocated to New York as follows:

> Although ***Michaelson*** [sic] resolved the issue concerning the total compensation that may be includable in the New York source income [footnote omitted] of a nonresident, the court did not address how the total amount should be allocated for New York purposes if the employee performs (or performed) services both inside and outside the state. Since the court determined that compensation constitutes the appreciation in the value of the stock form the date of grant to the date of exercise, that period is considered the period over which the employee's performance of services will be measured (compensable period).
>
> Therefore, based upon sections 132.4(c) and 132.18 of the Personal Income Tax Regulations, it is the Tax Department's position that any allocation must be based on the allocation applicable to regular (non-option) compensation received by the employee during the compensable period. The allocation is computed by

> multiplying the compensation attributable to the option by a fraction whose numerator is the total days worked by the employee inside New York State during the compensable period, and whose denominator is the total days worked by the employee both inside and outside the state during the compensable period. However, if an employee exercises an option after terminating employment with the employer who granted the option, the compensable period, and therefore the allocation, is limited to the days worked inside and outside the state during the period from the date of grant to the date employment ceases.

Developoment of the 1995 TSB Memorandum on Taxation of Income From Stock Options

38. A little more than two years after the 1986 Court of Appeals decision in ***Michaelsen,*** Gabriel DiCerbo, as director of the Taxpayer Services Division, called for a meeting of representatives of the Division's former Law Bureau, Audit, and Technical Services to resolve issues regarding the taxation of stock options received by nonresidents from their employers. According to Mr. DiCerbo, the Court of Appeals decision in ***Michaelsen*** and the Appellate Division Third Department's decision in ***Donahue v. Chu***, 104 AD2d 523, 479 NYS2d 889 "have created a great amount of confusion both for the public and in the department as to the proper method of taxing stock options . . . ." Mr. DiCerbo further noted that there were:

> [D]ifferences of opinion within the department as to how these items [stock options and restricted stock] should be taxed.
>
> In order to assure that correct and consistent rules are applied to these transactions, it is suggested that a meeting take place as soon as possible between representatives of the Law Bureau, Audit and Technical Services to resolve these issues.

The confusion within the department noted by Mr. DiCerbo is reflected in a tax technician's letter on the letterhead of the Technical Services Bureau dated October 15, 1987, more than a year after the Court of Appeal's decision in **Michaelsen**, to an unrelated taxpayer,

whose name was redacted by petitioner on the exhibit submitted into evidence. Such taxpayer was advised with regard to the allocation of stock option income as follows:

> [W]hen a nonresident works partly within and partly without New York State, the allocation of the stock option is based upon the wage allocation in the year the stock option was exercised.

39. At a meeting held on November 21, 1988 to address Mr. DiCerbo's concerns, it was decided, according to handwritten notes prepared by a participant at the meeting, Kenneth Brand, a tax regulation specialist in the Technical Services Bureau and the Division's in-house expert on the taxation of stock options, that stock option income "would be allocated to New York based upon the allocation in effect during the period from the date the option is granted to the date of exercise." However, implementation of this decision was contingent on an investigation by the Division's then Bureau of Law/Litigation. The memorandum dated July 25, 1989, detailed in Findings of Fact "36" and "37", served as the approval by the Bureau of Law/Litigation of the allocation methodology decided upon at the meeting on November 21, 1988.

40. Mr. Brand noted that the 1986 Court of Appeals decision in ***Michaelsen*** "changed the way that we taxed stock options from the past" (tr., p. 209). At the meeting on November 21, 1988, Mr. Brand obtained a copy of a training guide for auditors dated November 20, 1974 concerning the taxation of stock options, which seems to be one of the bases for his opinion that ***Michaelsen*** changed the way the Division taxed stock options. This 1974 training guideline provided as follows with regard to the allocation to New York of stock option income received by a nonresident:

> Allocation is to be made on the same basis as is used for allocating compensation for the tax year in which the option is exercised unless:
> (1) Conditions of employment are greatly different form the regular employment activities of the employee during the period the option was earned

> (retirement, change of office, change of employer, change of duties, sickness, etc.), or
>
> (2) Taxpayer presents evidence to show current year allocation is not reasonable or that an alternative method is more equitable.
>
> Since allocation of income is primarily a factual problem, judgment on the part of the examiner is required to arrive at an equitable solution. In unusual or questionable cases the examiner should consult with his supervisor.

41. Furthermore, in a series of decisions[9] in the late 1970's and early 1980's, the former State Tax Commission allocated stock option income of nonresidents to New York based upon the nonresident's basis for allocating compensation for the tax year in which the option was exercised.

42. At Mr. DiCerbo's direction, Kenneth Brand, soon after receipt of the memorandum dated July 25, 1989 of the former Bureau of Law/Litigation, set about preparing a Technical Services Bureau Memorandum ("TSB-M") to advise the public of the Division's change in policy. Mr. Brand was primarily responsible for the development of the Technical Services Bureau's 1995 memorandum described in Finding of Fact "37". By early 1990, he had prepared a draft Technical Services Bureau memorandum that five years later would be issued as TSB-M-95-(3)(I), as described in Finding of Fact "37". The 1990 draft prepared by Mr. Brand was circulated widely in the Department of Taxation and Finance by a memorandum dated April 6, 1990 on the letterhead of the Technical Services Bureau, which, in relevant part, included the following impact statement:

> 3. *Impact on Taxpayer Groups*: These changes will affect those nonresident and part-year resident employees working in New York State who receive stock options and restricted stock. The new allocation method should, generally, be more fair and equitable since it takes into account the entire compensation period. Under prior policy, the allocation was based only upon the year of exercise.
>
> 4. *Effect on Current Policy*: The portion of the memorandum dealing with the impact of the **Michaelson** [sic] case reflects our current policy. The portion

[9] These decisions by the State Tax Commission are discussed in the Conclusions of Law.

> dealing with allocation reverses our current policy, which was to allocate the income based upon the year of exercise. However, in light of the **Michaelson** [sic] case, our prior position is no longer deemed appropriate.

43. The Division maintains that the methodology for allocating a nonresident's stock option income to New York agreed upon at the 1988 meeting was required by the Court of Appeals decision in ***Michaelsen***. Consequently, the Division did not believe that it was necessary to promulgate a regulation in order to codify the methodology agreed upon at the 1988 meeting. However, there was some dissent in the Division's ranks, with Mr. DiCerbo, the then Director of the Technical Services Bureau expressing some apprehension about sending out a TSB memorandum "without having a regulation to back it up" in the words of Mr. Brand (tr. p. 240). In fact, during the spring of 1990, a draft regulation was prepared by Colleen Burns, a tax regulations specialist. However, the development of a regulation "never got past the rough draft stage" according to Ms. Burns (tr., p. 530). The draft regulation prepared by Ms. Burns included a regulatory impact statement that provided, in relevant part, as follows:

> *Effect on Current Policy*: The amendments dealing with the Court of Appeals decision which relate to the portion of the Federal gain on the sale of statutory stock options that is treated as compensation reflects our current policy. The amendments dealing with allocation reverse our current policy, which was to allocate the income based upon the year of exercise. However, due to the Court of Appeals decision, our prior position is no longer deemed appropriate.

Marilyn Kaltenborn, the chief of tax regulations during 1990, who estimated that in any given year there were approximately 60 projects to develop regulations, testified that she didn't "have a good recollection of [a regulations project dealing with stock option income on or about '90 through '93]" (tr., p. 480).

44. The record provides only some limited reasons for the five year delay in issuing the 1995 TSB memorandum in light of the fact that the draft memorandum was prepared in 1990 and

the Division's position that its policy on the allocation of income from the exercise of stock options had become finalized, pending approval for implementation by the Bureau of Law/Litigation, at the meeting on November 21, *1988*, as noted in Finding of Fact "39". A short delay can be explained by the project to develop a regulation, which as noted in Finding of Fact "43" was ended in a very preliminary stage. Mr. Brand, who described TSB-M's, in general, as informational, distinguished between mandatory and discretionary TSB-M's. According to Mr. Brand, the 1995 TSB-M-95(3)(I) on stock option income was discretionary:

> The mandatory types are the ones issued on new legislation to implement budget bills and that type of thing. Those are ones that we were normally directed to do as part of an implementation process. The discretionary ones are ones that we issue where we know there [are] problems out there that maybe people aren't understanding things and that type of issues, but it's not something we are mandated or necessarily scheduled to do (tr., p. 228).

Mr. Brand testified that work on TSB-M's was "getting backed up" due to personnel shifts, and because the 1995 TSB-M on stock option income was discretionary, it was delayed because "there [were] a lot of revenue, rate and budget things we were mandated to get stuff out on" (tr., p. 239).

45. Marilyn Kaltenborn, who currently serves as the Division's director of the Taxpayer Services Division and as noted in Finding of Fact "43" was the chief of tax regulations during 1990, described TSB-M's issued by her division as:

> [T]he drafter's best understanding of the audit policy. We are not part of the audit division, so that statement may or may not be totally agreed to by the audit division. It's our best understanding of the policy. [Tr., p. 483.]

46. The 1995 TSB-M-95(3)(I) issued on stock option income did not vary substantively from the draft TSB-M prepared by Mr. Brand in 1990. The draft which was circulated for comments received only technical and grammatical suggestions for improvements except for one

substantive proposal by Nicholas Gugie, a tax policy analyst in the Office of Tax Policy Analysis. Mr. Gugie in a memorandum dated July 7, 1995 agreed that the grant to exercise period for allocation "provides the theoretically correct approach for allocating gain on incentive stock options." Nonetheless, he suggested as an alternative that a period consisting of "the last year, and prior three years, of employment" should be an option for nonresident taxpayers "whose New York employment spans a number of years." Mr. Gugie pointed out that this alternative methodology was used to allocate certain retirement income such as deferred compensation in the tax regulations at 20 NYCRR 132.20. This alternative methodology was rejected by Mr. Brand in a memorandum dated July 25, 1995, in which he noted, in part, as follows:

> 2. The prescribed rule corresponds to the court's ruling in ***Michaelson*** [sic] and could be accomplished without regulatory change. Any other method, would be arbitrary to the current law and regulations and would require a regulatory change.
>
> 3. This proposed change does not reflect current audit policy, as does the prescribed method.

47. There is no evidence in the record that the Division changed its method of allocating compensation from the exercise of stock options and earnings bonus units in order to target or punish petitioner for overseeing Exxon's relocation of its corporate headquarters from New York City to Dallas, Texas. Rather, both the auditor and her supervisor intended to allocate stock option income to New York by utilizing a workday ratio from the date of grant to the date of exercise in all cases where a nonresident taxpayer had recognized stock option income.

Consents Extending Period of Limitations for Assessment

48. Mr. Rawl[10] executed two consents, one dated December 4, 1992 and the second dated February 1, 1994, which extended the period of limitations for assessment of personal income tax for 1989 to April 15, 1994 and June 30, 1994, respectively. Petitioner's former representative, Helmer W. Arizmendy, executed three consents dated June 2, 1994, August 29, 1994 and September 27, 1994, respectively, which extended the period of limitations for assessment of personal income tax (i) for 1989 to September 30, 1994, (ii) for 1989 and 1990 to October 31, 1994, and (iii) for 1989 and 1990 to November 30, 1994.

49. Mr. Arizmendy represented petitioner in the course of the audit pursuant to a power of attorney executed by Mr. Rawl on his own behalf on November 16, 1992 and in his capacity as executor of his late wife's estate on December 4, 1992. This power of attorney appointed two representatives, Richard Funk and Helmer W. Arizmendy, both associated with U.S. Trust Company of New York, which was designated in the line for "firm's name". U.S. Trust Company of New York was the paid preparer for each of the three New York nonresident income tax returns at issue. Mr. Arizmendy signed the 1990 and 1991 tax returns as the paid preparer, while neither he nor Mr. Funk but rather a third person associated with U.S. Trust Company of New York, whose signature is not easily decipherable but is clearly different from the signatures of Mr. Funk and Mr. Arizmendy, signed as the paid preparer of the 1989 return. Mr. Rawl appointed Mr. Funk and Mr. Arizmendy as his "true and lawful attorney or agent, to appear and represent me before the Department of Taxation and Finance in connection with a proceeding involving: New York Nonresident Personal Income Tax for 1989, 1990, 1991". Mr. Rawl's

[10] Petitioner also executed the consents in his capacity as executor for his late wife's estate. Mr. Rawl was appointed executor of Betty E. Rawl's will and estate on April 6, 1992 by the Probate Court of Dallas County, Texas.

execution of the power of attorney was acknowledged before a notary public. However, in the section of the power of attorney described as the "Declaration of Representative and Notice of Appearance", only Richard Funk signed the instrument while also checking off the box to indicate that he was "a certified public accountant duly qualified to practice in New York State". Mr. Arizmendy did not sign this "Declaration of Representative and Notice of Appearance". Nonetheless, the auditor never met with anyone other than Mr. Arizmendy from U. S. Trust Company.

50. The auditor noted that before she obtained a breakdown of petitioner's income for 1991, Mr. Arizmendy "needed to get Mr. Rawl's permission to give me that information"(tr., p. 93). In the summer of 1993, approximately a year after the audit had been assigned to her, the auditor received the information concerning the breakdown of petitioner's income for 1991 from Mr. Arizmendy The auditor's log reflects the auditor's many contacts with Mr. Arizmendy, in his capacity as petitioner's representative, concerning the audit at issue. Even after petitioner's current representatives became involved in the spring of 1994, Mr. Arizmendy continued to represent petitioner for audit purposes

51. In the fall of 1994 while she was completing her audit report and organizing documents, the auditor discovered that Mr. Arizmendy had not signed the declaration of representative and notice of appearance section of the power of attorney. She made a pencil notation on her log, later erased[11], in order to discuss the power of attorney with her supervisor. After discussing the matter of the power of attorney with her supervisor, the auditor decided that

[11] Petitioner's representative noticed the erasure which prompted vigorous cross-examination of the auditor.

nothing further should be done in response to Mr. Arizmendy's failure to sign the declaration of representative and notice of appearance.

52. The Division submitted 23 proposed findings of fact. Proposed findings of fact "1", "2", and "6" through "22" are accepted and incorporated into this determination.

53. Proposed findings of fact "3", "4", and "5" are accepted with an explanation:

(i) Proposed finding of fact "3" provides that "[t]here is no evidence in the record whereby Mr. Rawl states that he relied on a strict year-of-exercise rule for purposes of sourcing his 1991 stock option income". As noted in Finding of Fact "7", a finding of fact has been made that after consultation with tax experts and research of the issue, petitioner's tax returns were prepared based upon the year of exercise rule for allocating income from stock options. Consequently, although it might be technically correct that there is no evidence in the record that supports a finding that Mr. Rawl himself stated that he relied on the year of exercise rule, his tax return for 1991 as prepared relied upon such rule. Further, the Division's use of the terminology "*strict* year-of-exercise rule"(emphasis added) is rooted in its argument that its prior policy before ***Michaelsen*** consisted of a "*general* year-of-exercise rule with notable exception" rather than a strict year of exercise rule [emphasis in original] (Division's brief, p. 14). This argument is best addressed in the Conclusions of Law rather than in this analysis of the Division's proposed finding of fact "3";

(ii) Proposed finding of fact "4" provides that "There is nothing in the record whereby Helmer W. Arizmendy states that he relied on a strict year-of-exercise rule for purposes of sourcing Mr. Rawl's 1991 stock option income." As noted in Finding of Fact "34", a finding of fact has been made that Mr. Arizmendy raised the issue that petitioner did not have to allocate any income from his exercise of stock options and the maturity of earnings bonus units in 1991 to

New York because such items of income were forfeitable until they were realized in 1991, a year in which petitioner had no Exxon workdays in New York. Although this forfeitability argument might not be a "strict year-of exercise rule", it nonetheless relied upon the year of exercise, when petitioner no longer worked any days in New York, as the period for determining whether any part of the income from the stock options and earnings bonus units was allocable to New York. Furthermore, petitioner's tax return for 1991 as prepared relied upon a year of exercise rule, and as noted in subparagraph "i" above, the Division's argument that its pre-***Michaelsen*** policy consisted of a general year of exercise rule with exceptions rather than a strict year of exercise rule is best addressed in the Conclusions of Law;

(iii) Proposed finding of fact "5" provides that the *sole* basis advanced by Mr. Arizmendy for not allocating any portion of the stock option income to New York was "forfeitability". As noted in subparagraph "ii" above, this forfeitability argument did, in fact, rely upon the year of exercise for determining the allocation percentage to New York.

54. Proposed finding of fact "23" provides that:

> Upon the issuance of the July 25, 1989 Memorandum from Law Bureau attorney Elizabeth McNulty [Exhibit PP], anyone who called the Technical Services Bureau would have been informed of the stock option allocation approach set out in that Memorandum.

Based upon the testimony of Kenneth Brand, it is more accurate to find that if a person contacted Mr. Brand's specific unit within the Technical Services Bureau such information would have been provided. However, Mr. Brand pointed out:

> There is also a phone bank operation [within the Technical Services Bureau] that has an eight hundred number. I can't speak for what they might be doing. I mean they have the staff of hundreds of people. I can only speak for what my unit would respond to in the context of phone calls or what type of phone calls would be responded to (tr., p. 336).

Further, Mr. Brand added that he did not know whether "the phone bank people [were] made aware of the decision that had been reached on July 25, 1989" (tr., p. 336).

SUMMARY OF THE PARTIES' POSITIONS

55. The Division maintains that the consents to extend the period of limitation for assessment of 1989 and 1990 income tax against petitioner executed by Mr. Arizmendy were effective so that the Notice of Deficiency dated November 14, 1994 was timely for 1989 and 1990. Citing the Tax Appeals Tribunal decision in ***Matter of White Carriage Corp.*** (May 16, 1994), the Division argues that the grant of authority by petitioner to Mr. Arizmendy to represent him on the audit at issue "is entirely unaffected by an irregularity, assuming there is one, [in] the notice of appearance" (Division's brief, p. 27).

The Division also contends that petitioner was not *required* or *mandated* by Exxon to serve as an outside director of Warner Lambert and Champion International Corp. Consequently, days which petitioner spent at board meetings of these two corporations at locations outside of New York may not be counted as Exxon workdays. According to the Division, petitioner received compensation from Champion International Corp. so that his directorship of Champion International Corp. is correctly viewed as "a separate employment" under its audit guidelines (Division's brief, p. 22). Although petitioner did not receive compensation from Warner Lambert, the Division argues that his membership on its board of directors "is nevertheless properly treated as separate employment" because it was not required or mandated by Exxon (Division's brief, p. 23).

The Division rejects petitioner's claim that the auditor contrived an allocation method to arbitrarily increase petitioner's 1991 tax liability because he had a zero allocation percentage to

New York for 1991. According to the Division, there is no basis for petitioner's "insinuations that [TSB-M-95-I(3)] may have been promulgated to bolster this particular audit or to cover the audit division's tracks [in selectively targeting Mr. Rawl][12]" (tr., p. 28). Rather, the Division argues that the tax regulations do not require "a strict year-of-exercise . . . methodology" for allocating stock option and earnings bonus units income to New York (Division's brief, p. 28). The memorandums prepared by John Coniglio of field audit management and by Elizabeth McNulty of the former Bureau of Law/Litigation were "interpretative statements of policy", in light of the Court of Appeals decision in ***Michaelsen v. New York State Tax Commission***, 67 NY2d 579, 505 NYS2d 585, "which provide guidance on the proper allocation of stock option income for nonresidents based on existing statutes and regulations and new case law" (Division's brief, pp. 30-31). According to the Division, "[t]he existing regulations on allocation provide ample support for the allocation methodology used on audit" (Division's brief, p. 31). Therefore, there was no requirement that the Division promulgate a new rule or regulation under Article 2 of the State Administrative Procedure Act in order to implement the grant to exercise methodology. In short, the auditor's methodology was rational and should be sustained. The Division rejects petitioner's reliance on the State Tax Commission decisions, which it contends do not present an unambiguous rule that the year of exercise should be used as the allocation methodology. According to the Division, there was never a strict year of exercise rule but rather "a *general*

[12] In his reply brief, petitioner noted that "now that facts have been developed at hearing" his speculation that he had been targeted by the Division proved incorrect (Petitioner's reply brief, p.4). Nonetheless, petitioner points out that his prior speculation that he was being singled out for disparate treatment because he was the chief executive officer of a major corporation which had moved its headquarters outside of New York was justified given the "Division's failure to share any records, witnesses or information from its privileged internal cadre of rules, memoranda and meetings" (Petitioner's reply brief, p. 4).

year-of- exercise rule with notable exceptions" (Division's brief, p. 14) [emphasis in original]. The Division maintains:

> The Department of Taxation and Finance here has merely revised its stock option allocation approach to conform to case law of the highest court of the State. Contrary to Petitioner's arguments, while a change in policy was effectuated, there was no wholesale reversal of a diametrically opposed policy which existed before the post-***Michaelsen*** methodology was developed (Division's brief, pp. 32-33).

The Division's policy before the Court of Appeals decision in ***Michaelsen*** "was a general rule, year of exercise, but there were exceptions for changes in circumstances but actually the goal was to see a reasonable, equitable allocation. It wasn't a hard and fast rule" (tr., p. 509). In sum, the Division argues that principles established by the Court of Appeals in its decision in ***Michaelsen*** compelled the allocation methodology used in the Rawl audit.

56. Petitioner counters that the statute of limitations for assessment of additional tax for 1989 and 1990 had expired prior to the Division's issuance of the Notice of Deficiency dated November 14, 1994. According to petitioner, the consents extending the time period for assessment executed by Mr. Arizmendy on petitioner's behalf were invalid because the power of attorney appointing Mr. Arizmendy was not signed by him.

Petitioner maintains that his participation on the board of directors of Warner Lambert and Champion International Corp. were days worked on behalf of Exxon:

> Attendance at these meetings was necessary to give him the well-rounded and world-based knowledge that was expected of him as a leader of one of the most powerful and complex organizations in the world - - including governments.
>
> Attendance at these meetings was encouraged by Exxon . . . .
>
> And finally, sitting on boards of other corporations was an unwritten prerequisite to getting other qualified people to sit on Exxon's board (Petitioner's brief, p. 26).

Petitioner maintains that he was not on vacation in 1990 when he attended a meeting in Mexico "to learn of developments that would affect Exxon's employees and investments in the Middle East" on the eve of Desert Storm (Petitioner's brief, p. 27). Time spent at the conference of Independent Producers Association of America at the Denver-area golf resort were also Exxon workdays.

Petitioner contends that he properly allocated no part of his 1991 income from (i) stock options which were exercised, and (ii) earnings bonus units which matured because under the tax regulations, compensation must be "allocated based on the year of realization, *i.e.*, the year of exercise" (Petitioner's brief, p. 30). Since he had no Exxon workdays in New York during 1991, no part of such compensation was required to be allocated to New York (Petitioner's brief, p. 30). Petitioner points out that the regulations create specific exceptions for pensions and termination payments but not for compensation from stock options and earnings bonus units. Therefore, the general rule requiring allocation based on New York workdays in the year of realization of income applies. According to petitioner, this rule was "repeatedly applied in every precedential case on point" (Petitioner's brief, p. 31). The year of exercise rule "bore the [former] State Tax Commission's imprimatur" in its decisions before and even after ***Michaelsen*** (Petitioner's brief, p. 32). Petitioner maintains that "The Division's view that its regulations mandate the allocation of stock option income by nonresidents in the manner implemented on audit is irrational" (Petitioner's brief, p. 34). Rather, the regulations *require* an allocation based on workday factors in the year of exercise. Petitioner rejects the Division's argument that the regulations permit "notable exceptions" to the year of exercise rule, as delineated in a 1974 audit guideline which was *"not* published or shared with the public" (Petitioner's reply brief, p. 12) [emphasis in original]. Rather, pursuant to Tax Law § 631(c), the Division was required to adopt

regulations in order to apportion and allocation income of nonresidents to New York, and consequently the Division lacked statutory authority to act outside of the duly promulgated regulations in allocating petitioner's income to New York:

> The . . . hand-written notes, internal memoranda, or whatever else the Division keeps secreted in Building 9 cannot operate to 'amend' the regulations in any way (Petitioner's brief, p. 30).

In addition, petitioner argues that the Division's attempt to depart from the long-standing year of exercise policy without prior public notice is arbitrary and capricious. The Court of Appeals in ***Howard Johnson Co. v. State Tax Commission,*** 65 NY2d 726, 492 NYS2d 11 "unequivocally stated that the Division could not change a publicly stated policy on a 'retroactive' basis" (Petitioner's brief, p. 45). Petitioner emphasizes that "the impact statement that preceded circulating drafts of TSB-M-95(3)(I) in 1990, made it clear that the Division was changing its policy" (Petitioner's brief, p. 47). The Division did not provide public notice of the change until 1995 when TSB-M-95(3)I was finally issued. Petitioner rejects the Division's "call us anytime defense":

> First off, it is only wishful thinking on the Division's part that a phone call would have resulted in a taxpayer actually learning of the [grant to exercise allocation methodology].
>
> Does the Division really mean to suggest that it is free to change its rules in private, refuse access to written records of the change under a claim of privilege, and then sit back and fault taxpayers for not calling up and asking what the current state of the Division's rules might be? (Petitioner's reply brief, p. 9.)

Furthermore, according to petitioner, in order for the Division to change its policy on the methodology for allocating compensation from stock options and earnings bonus units, it was required to amend its regulations by promulgating the new policy as a rule in compliance with the State Administrative Procedures Act, the Executive Law, and the New York State Constitution. By failing to do so, the Division violated petitioner's constitutional right to due

process of law. Petitioner maintains that "common sense and the law tell you" that the Division cannot "change its rule governing the allocation of stock option income by non-residents behind closed doors, and then implement that change before it promulgates a regulation, before it complies with [the State Administrative Procedures Act], and before it tells a single taxpayer" (Petitioner's reply brief, p. 2).

CONCLUSIONS OF LAW

A. Tax Law § 651(a)(3) requires every nonresident individual, which is petitioner's uncontested status[13], who has New York source income for the taxable year to make and file a New York personal income tax return.

B. The starting point for determining what constitutes New York source income for a nonresident is Tax Law former[14] § 631, which in relevant part, provided the following statutory definition:

> (a) General. The New York source income of a nonresident individual shall be the sum of the net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income . . . derived from or connected with New York sources . . . .
>
> (b) Income . . . from New York sources.
>
> (1) Items of income . . . derived from or connected with New York sources shall be those items attributable to:
>
> (A) the ownership of any interest in real or tangible personal property in this state; or
>
> (B) a business, trade, profession or occupation carried on in this state; or
>
> * * * *
>
> (2) Income from intangible personal property, including annuities, dividends, interest, and gains from the disposition of intangible personal property, shall constitute income derived from New York sources only to the extent that

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[13] During 1989 and up to the late summer of 1990, petitioner was a resident of Connecticut and during the latter part of 1990 and 1991, he was a Texas resident.

[14] Tax Law § 631 has been amended since the years at issue in ways that do not affect the outcome of this matter.

> such income is from property employed in a business, trade, profession, or occupation carried on in this state.
>
> * * * *
>
> (c) Income . . . partly from New York sources. If a business, trade, profession or occupation is carried on partly within and partly without this state, as determined under regulations of the tax commission,[15] the items of income, gain, loss and deduction derived from or connected with New York sources shall be determined by apportionment and allocation under such regulations.

C. As noted in Finding of Fact "1", the principal business of petitioner's life for 43 years was his employment by Exxon Corporation. During 1989 and 1990, it is uncontested that he "carried on" this employment, in his capacity as chairman and chief executive officer of Exxon, "partly within and partly without" New York.

D. Since petitioner in 1989 and 1990, in the statutory language of Tax Law § 631(c), "carried on [his Exxon employment] partly within and partly without" New York, the auditor's allocation of Mr. Rawl's income from Exxon during 1989 and 1990 must be evaluated based upon a close review of the methodology set forth in the tax regulations promulgated by the former State Tax Commission, pursuant to the specific Legislative delegation, as noted in Tax Law § 631(c), that apportionment and allocation of income partly derived from New York sources "shall be determined" by the former State Tax Commission's (now the Division's) regulations.

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[15] Effective September 1, 1987, under Tax Law § 2026, references to the State Tax Commission in the Tax Law, in all instances other than in relation to the administration of the administrative hearing process, are deemed to refer to the Division of Taxation or Commissioner of Taxation and Finance.

E. The tax regulations at 20 NYCRR 132.15-132.24[16] provide, in relevant part, as follows with regard to "Methods of Allocating Income and Deductions From Sources Within and Without New York State":

> § 132.15 *Apportionment and allocation of income from business carried on partly within and partly without New York State.*
>
> (a) If a nonresident individual . . . carries on a business, trade, profession or occupation both within and without New York State, the items of income . . . attributable to such business, trade, profession or occupation must be apportioned and allocated to New York State on a fair and equitable basis in accordance with approved methods of accounting.
>
> * * * *
>
> § 132.18 *Earnings of nonresident employees and officers.*
>
> (a) If a nonresident employee (including corporate officers . . .) performs services for his employer both within and without New York State, his income derived from New York State sources includes that proportion of his total compensation for services rendered as an employee which the total number of working days employed within New York State bears to the total number of working days employed both within and without New York State. . . . However, any allowance claimed for days worked outside New York State must be based upon the performance of services which of necessity, as distinguished from convenience, obligate the employee to out-of-state duties in the service of his employer. In making the allocation provided for in this section, no account is taken of nonworking days, including Saturdays, Sundays, holidays, days of absence because of illness or personal injury, vacation, or leave with or without pay.
>
> *Example 1:* A, a resident of Connecticut, is an officer and substantial stockholder of the X Corporation, having its principal office in New York City. During the taxable year, A performs the following services for X Corporation:
>
> | | |
> |---|---|
> | Services performed for X Corporation wholly within New York State. | 210 days |
> | Sales conventions in Hot Springs, Ark, and Miami, Fla. (A passed through New York State to board airplanes on four of these days.) | 10 days |
> | Calling on customers in Pacific Coast states | 20 days |

[16] The tax regulations currently found at Part 132 (for example, 20 NYCRR 132.15-132.24, were previously codified at Part number 131 (for example, 20 NYCRR 131.15-131.24). None of the relevant language of the tax regulations discussed in the conclusions of law was changed when the regulations were renumbered in 1992. For ease of reference, citations will be to the current regulation numbers at Part 132.

A's salary from the X Corporation is $40,000 per year.

A's New York adjusted gross income is determined as follows: Total number of working days within New York State (210) divided by total number of working days both within and without New York State (240) is 210/240 or 87.5 percent, which, when applied against A's salary of $40,000, equals $35,000, A's New York adjusted gross income. Days on which A entered New York State solely for the purpose of boarding or disembarking from an airplane or train do not count as days worked in New York State.

* * * *

§ 132.24 *Other methods of allocation.*

Sections 132.15 through 132.23 of this Part are designed to apportion and allocate to New York State, in a fair and equitable manner, a nonresident's items of income . . . attributable to a business, trade, profession or occupation carried on partly within and partly without New York State. Where the methods provided under those sections do not so allocate and apportion those items, the department may require a taxpayer to apportion and allocate those items, under such method as it prescribes, as long as the prescribed method results in a fair and equitable apportionment and allocation. A nonresident individual may submit an alternative method of apportionment and allocation with respect to items of income . . . attributable to a business, trade, profession or occupation carried on partly within and partly without New York State. The proposed method must be fully explained in the taxpayer's New York State nonresident personal income tax return. If the method proposed by the taxpayer is approved by the department, it may be used in lieu of the applicable method under sections 132.15 through 132.22 of this Part.

F. The question to be resolved, in determining whether the eight days in 1989 and the ten days in 1990 when petitioner attended meetings of the boards of directors (i) of Warner Lambert in New Jersey and Paris, France and (ii) of Champion International Corp. in Connecticut may be counted as Exxon workdays outside of New York, is whether petitioner's attendance at such meetings represented, in the above regulation's terminology, "services rendered as an employee" of Exxon. Petitioner has shouldered his burden of establishing that his attendance at the meetings of these two outside corporations, in fact, did represent services rendered by him to Exxon.

After review by the Exxon board of directors, petitioner was permitted to accept these two outside directorships. As noted in Finding of Fact "19", Exxon, in fact, encouraged petitioner to participate on the boards of directors of Warner Lambert and Champion International Corp. in order to provide Mr. Rawl, its chairman and chief executive officer, with a broader perspective on the global economy, which benefitted Exxon. Warner Lambert, as a global corporation in the health care and personal consumer products and confectionery business, and Champion International Corp., as a major supplier of paper and wood products, presented Mr. Rawl with the ability to expand his awareness of the global economy, clearly necessary for the chief executive officer of the world's fifth largest industrial company. In addition, by petitioner's participation on Warner Lambert's board of directors, the chairman of Warner Lambert, in turn, served on Exxon's board of directors, which directly benefitted Exxon. The Division's argument that petitioner's attendance at these outside board meetings was not *required* by Exxon imposes a stricter standard then the one set forth in the applicable regulations, that the services outside New York represent services rendered to an employer.[17] Petitioner rendered services to Warner Lambert and Chamption International Corp. by attending the meetings of their respective boards of directors. Nonetheless, at the same time, he served Exxon's interests foremost, and consequently his attendance at such meetings may properly be viewed as services rendered to Exxon. The 18 days over a 2 year period, which petitioner spent attending meetings of the boards of directors of Warner Lambert and Champion International Corp., are therefore to be counted as Exxon workdays outside of New York.

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[17] The regulations require that the services performed out-of-state must be performed out-of-state "of necessity" and not for the employee's "convenience", which is not at issue herein since the outside corporations, not petitioner, determined the location of their board meetings.

G. A similar analysis, as was done in Conclusion of Law "F", is necessary in order to determine whether the three days in February spent by petitioner in Mexico and the three days in July spent by him in Colorado during 1990 should also be treated as Exxon workdays outside of New York. It is concluded that petitioner has proven that he rendered services as an employee of Exxon on these particular days. As noted in Findings of Fact "23" and "24", the three days spent in Mexico involved discussions concerning security in the Middle East with a high level governmental official which directly affected Exxon's interests. Such discussions were clearly related to petitioner's employment as Exxon's chief executive officer. Likewise, petitioner's attendance at the conference of the Independent Producers Association of America served Exxon's interests in developing contacts and relationships with members of this association who engage in wildcatting, exploration and drilling of oil wells and reserves in the United States and abroad. It is noted that Example 1 of 20 NYCRR 132.18 detailed in Conclusion of Law "E" treats days attending conventions as workdays.

H. As noted in Finding of Fact "25", the facts concerning petitioner's attendance at the meeting of the Independent Producers Association of America were based upon Mr. Rawl's affidavit dated January 19, 1998. Citing ***Matter of Orvis v. Tax Appeals Tribunal***, 86 NY2d 165, 630 NYS2d 680, ***cert. denied***, 516 U.S. 989, the Division contends that no weight should be given to this affidavit. This contention is rejected since, unlike the situation in ***Orvis***, there is no inconsistent and contradictory evidence in the record concerning petitioner's attendance at this meeting of the Independent Producers Association of America in July of 1990. Therefore, Mr. Rawl's affidavit is properly given weight.

I. Turning to the central issue in this matter, whether a nonresident's income from the exercise of stock options and the maturing of earnings bonus units is subject to New York

personal income tax, when during the year of exercise, the nonresident had no workdays in New York, it is first noted that under Tax Law § 631(b)(2),[18] a nonresident's investment income is *not* subject to New York personal income tax. Not until the 1986 Court of Appeals decision in ***Michaelsen v. New York State Tax Commission,*** 67 NY2d 579, 505 NYS2d 585 was it finally resolved that the stock option income of a nonresident who worked in New York was *not* investment income but rather was compensation attributable to a "business, trade, profession or occupation carried on" in New York so that it was properly subject to New York personal income tax.

J. Since the Court of Appeals decision in ***Michaelsen*** is pivotal to this determination, a close review of its facts and case history is helpful. James A. Michaelsen, a senior executive working for Avon Products, Inc. ["Avon"] in New York City, was granted stock options in Avon capital stock pursuant to a qualified employee stock option plan in 1968. On March 13, 1972, he exercised some of his stock options by purchasing 3,000 shares of Avon stock, and approximately a year later, on February 22, 1973, he exercised additional stock options by purchasing 3,000 more shares. Subsequently, in 1973, he sold all 6,000 shares and reported a gain of $179,761.00 for 1973 Federal income tax purposes. Mr. Michaelsen, a resident of Connecticut, did not report any part of that gain of $179,761.00 on his nonresident New York income tax return for 1973.

K. The State Tax Commission in its decision in ***Matter of Michaelsen*** (February 4, 1983), *aff'd*, 122 Misc.2d 824, 471 NYS2d 789, *rev'd, 107 AD2d 389, 486 NYS2d 479, modified, 67 NY2d 579, 505 NYS2d 585,* treated Mr. Michaelsen's stock options as a form of compensation

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[18] The statutory exception to this rule is income "from [intangible personal] property employed in a business, trade, profession, or occupation" carried on in New York, which is not applicable to petitioner.

from Avon, his New York employer, granted to him "for past services to Avon or as an incentive for future services to Avon." Therefore, according to the Commission, the gain he recognized from his sale of the 6,000 shares of Avon stock in 1973 "constitutes compensation and is connected with New York sources." The Commission directed that such income was to be included in Mr. Michaelsen's New York adjusted gross income for 1973. In its findings of fact, the Commission noted that petitioner agreed with the Audit Division's increase to his allocation ratio for 1973 from 221/287 (77.0034%) to 227/287 (79.0940%). Although the Commission did not explicitly address the issue, it is reasonable to presume that this allocation ratio for 1973 of 79.0940% was applied to Mr. Michaelsen's income from his sale of the 6,000 shares of Avon stock in 1973. Although the facts show that the stock options were granted in 1968 and that stock options representing 3,000 shares of the total 6,000 shares were exercised in 1972 (with stock options representing the other 3,000 shares exercised in 1973), the allocation percentage used to calculate Mr. Michaelsen's tax due on his stock option income was the percentage for 1973.

L. The Supreme Court in ***Michaelsen v. New York State Tax Com'n,*** 122 Misc2d 824, 471 NYS2d 789, *rev'd*, 107 AD2d 389, 486 NYS2d 479, *modified*, 67 NY2d 579, 505 NYS2d 585, dismissed Mr. Michaelsen's Article 78 proceeding to annul the State Tax Commission's decision noting that the State Tax Commission's decision had a rational basis because:

> [T]here was no evidence indicating that the options through which the stock was acquired were issued other than as a form of compensation to petitioner James Michaelsen for either past services or incentive for future services to his employer (***Michaelsen, supra***, at 790).

Supreme Court rejected Mr. Michaelsen's argument that the stock option income was not subject to New York personal income tax as income from intangible personal property under Tax Law §

631(b)(2) because that section was "not meant to cover taxpayers who receive stock options in lieu of compensation" (***Michaelsen, supra***, at 790). Supreme Court did not address the allocation percentage to be used in calculating the portion of the stock option income subject to New York personal income tax.

K. The Appellate Division in its decision (later to be modified by the Court of Appeals) in ***Michaelsen v. New York State Tax Com'n***, 107 AD2d 389, 486 NYS2d 479, *modified*, 67 NY2d 579, 505 NYS2d 585, declared that the State Tax Commission, and Supreme Court by affirming the Commission, were incorrect in treating the "appreciation of the market value of the stock in Avon" as connected with the rendering of services by Mr. Michaelsen to Avon in New York (***Michaelsen, supra,*** at 481). Rather, according to the Appellate Division, "the only income attributable to New York is the value of the stock option on the date it became exercisable" (***Michaelsen, supra***, at 481).

L. The Court of Appeals rejected the Appellate Division's position in its decision in ***Michaelsen v. New York State Tax Com'n***, 67 NY2d 579, 505 NYS2d 585. Rather, the Court of Appeals decided that the difference between the fair market value of the Avon stock and Mr. Michaelsen's option price at the time he exercised the options is properly treated as compensation to Mr. Michaelsen from his Avon employment. The Court of Appeals pointed out the following error in the Appellate Division's decision:

> Taxing only the difference between the fair market value of the stock on the date the option is first exercisable and the option price differs from Federal law and leaves much of the compensation to the employee untaxed. Plainly the option on the date it becomes exercisable is worth more than merely the difference between the fair market value of the stock at that time and the option price. Indeed, they are usually the same. The employee's compensation comes from employer's willingness to let the employee benefit from market appreciation in the stock without risk to his own capital. . . . [T]his extra value cannot be adequately measure on the date the option becomes exercisable . . . . [W]e

> conclude that the proper method of valuing the compensation derived from an option that has no readily ascertainable fair market value on the date it is granted is to subtract the option price from the fair market value of the stock on the date the option is exercised (***Michaelsen, supra***, 505 NYS2d at 588-589).

The Court of Appeals fine-tuned the method of valuation, which it noted was agreed to by the State Tax Commission, as follows:

> Any gain petitioner realized from an increase in the market value of Avon stock between the time the option was exercised and the time the stock was sold is clearly investment income rather than compensation and, as a nonresident, petitioner cannot be taxed on this amount (***Michaelsen, supra***, 505 NYS2d at 589).

Because the record did not reveal the value of the Avon stock on the dates the options were exercised, the matter was remitted to the State Tax Commission:

> [F]or an appropriate assessment of tax based upon the difference between the option prices and the fair market value of the stock when the options were exercised" (***Michaelsen, supra***, 505 NYS2d at 589).

The Court of Appeals did not address the allocation percentage to be applied to Mr. Michaelsen's stock option income. Consequently, it is reasonable to presume that the allocation ratio for 1973 of 79.0940% was used.

M. As noted in Finding of Fact "43", the Division maintains that the decision of the Court of Appeals in ***Michaelsen, supra***, *required* that a nonresident's stock option income be allocated to New York based upon a grant to exercise allocation period rule. However, based upon the above analysis of the 1986 Court of Appeals decision in ***Michaelsen, supra***, the Division's position is rejected. As noted in Finding of Fact "39", the memorandum dated July 25, 1989 on behalf of William F. Collins, the Division's former Deputy Commissioner and Counsel to Gabriel DiCerbo, the former director of the Taxpayer Services Division served as the approval by the Bureau of Law/Litigation of the grant to exercise allocation period rule . It is noted that even

this memorandum did *not* state that the Court of Appeals decision *required* the grant to exercise allocation period rule. Rather, the memorandum, as noted in Finding of Fact "36", noted that:

> It *seems logical* that since the gain accruing over the period from grant to exercise is considered compensation under Michaelson [sic], the entire period should be considered the intended compensable period of the option. The entire period should *accordingly* be taken into account for State purposes in determining allocation of the gain to New York (emphasis added).

Similarly, as noted in Finding of Fact "46", in rejecting an alternative methodology suggested by a taxpayer policy analyst in the Office of Tax Policy analyst, Kenneth Brand, the drafter of the 1995 Technical Services Bureau memorandum issued on stock option income, noted merely that the grant to exercise allocation period rule "*corresponds*" to the Court of Appeals decision in ***Michaelsen, supra,*** and in his impact statement preceding the draft TSB-M he prepared, as noted in Finding of Fact "42", Mr. Brand noted that the year of exercise methodology in light of ***Michaelsen*** was "no longer deemed *appropriate.*". In sum, Mr. Brand and the Bureau of Law/Litigation memorandum are correct that the grant to exercise allocation period rule is *logical, appropriate,* and *corresponds* to the 1986 Court of Appeals decision. However, it was not *required* by the court's decision. The methodology for allocating to New York was *not* even addressed by the court. At most, the Court of Appeals confirmed *sub silentio* the State Tax Commission's calculation of tax due which was based on the allocation percentage during 1973, the year in which the remaining 50% of Mr. Michaelsen's stock options were exercised. The other 50%, as noted above, were exercised in 1972. Clearly, the State Tax Commission did not use a grant to exercise allocation period rule. Moreover, even TSB-M-95-(3)I, as noted in Finding of Fact "37", emphasized that "the court did not address how the total amount should be

allocated for New York purposes if the employee performs (or performed) services both inside and outside the state."

N. The Division also has argued that it never had a *strict* year of exercise methodology for allocation stock option income to New York, pointing to the 1974 training guideline detailed in Finding of Fact "40" and the section in the tax regulations at 20 NYCRR 132.24 as noted in Conclusion of Law "E", which authorizes "other methods of allocation" in order to obtain "a fair and equitable apportionment and allocation." However, the record establishes that, in fact, the year of exercise methodology for allocating stock option income was viewed by the former State Tax Commission, as reflected in its decisions[19] which expressed the then existing audit policy, and by individuals throughout the Division as *the methodology* for allocating stock option income without exception.

O. For example, the State Tax Commission approved the use of the year of exercise methodology for allocating stock option income, irregardless of any fairness requirement, in ***Matter of Christensen*** (August 26, 1977). In 1968, a stock option was granted to Mr. Christensen by his employer, IBM, four years before he commenced employment with IBM in New York in 1972, when he exercised the stock option. From 1968 until his employment in New York, Mr. Christensen had been an employee of IBM in France. Nonetheless, in allocating the 1972 stock option income of Mr. Christensen, a nonresident living in Connecticut, to New York, the Commission used the year of exercise methodology.

P. Furthermore, in addition to the State Tax Commission decisions noted above, the record includes additional evidence that the year of exercise rule, without any exception, was the Division's policy before it implemented the date of grant to exercise rule. As noted in Finding of Fact "42", the impact statement preceding

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[19] In addition to the decision of the State Tax Commission in ***Matter of Christensen*** (August 26, 1977) discussed in detail in Conclusion of Law "O", the year of exercise methodology was used by the Commission to allocate a nonresident's stock option income to New York for income tax purposes in the following additional matters: ***Matter of Michaelsen*** (October 13, 1978) [an earlier matter involving the same taxpayer as ***Matter of Michaelsen*** (February 4, 1983), ***supra***]; ***Matter of Woolard*** (June 18, 1982); and ***Matter of Tobin*** (January 24, 1983). The State Tax Commission in ***Matter of Duffy*** (November 12, 1986) left intact the use of the year of exercise methodology by the Audit Division although it remanded back to the former Tax Appeals Bureau for further hearing in order to develop facts concerning the option price, the fair market value of the stock on the dates the taxpayer exercised his option and the selling price of the stock upon disposition.

the draft TSB-M noted that "Under prior policy, the allocation was based only upon the year of exercise." It further provided that "The portion dealing with allocation *reverses* our current policy, which was to allocate the income based upon the year of exercise (emphasis added)." Similarly, the regulatory impact statement included in the draft regulation, as noted in Finding of Fact "43", noted that "The amendments dealing with allocation reverse our current policy, which was to allocate the income based upon the year of exercise." Further, even as late as a year after the issuance of the 1986 Court of Appeals decision in ***Michaelsen, supra***, as noted in Finding of Fact "38", the Technical Services Bureau by a letter dated October 15, 1987 was advising a taxpayer that "the allocation of the stock option is based upon the wage allocation in the year the stock option was exercised." In sum, it is concluded that the auditor's use of the grant to exercise period for allocating Mr. Rawl's 1991 stock option income and grant to maturity period for allocating his 1991 earnings bonus units income represented a *reversal* of the Division's prior policy of allocating such income by the use of workdays in the year of exercise or maturity.

Q. Most important, as noted in Finding of Fact "35", the auditor, in subjecting petitioner's compensation in 1991 from stock options and earnings bonus units to New York personal income tax , did not apply an allocation methodology based upon an exception to the year of exercise methodology as specified in the 1974 guidelines detailed in Finding of Fact "40" nor was she basing the assertion of tax due for 1991 in order to achieve a fair and equitable result based upon language in the tax regulations at 20 NYCRR 132.24. Rather, she based her adjustment for 1991 on the Division's new policy of a grant to exercise methodology for allocating a nonresident's compensation from stock options. As noted in Finding of Fact "5", Mr. Rawl's percentages for allocating his Exxon compensation to New York in the period 1986 until he moved to Texas in 1990 ranged from 50.59% to 78.11%. In 1991, when he reported a huge increase in his Exxon compensation from $1,706,214.00 in 1989 and $1,123,467.00 in 1990 to $$9,567,725.00 in 1991, he had a zero percentage for allocating Exxon compensation to New York, which understandably raised the interest of the auditor. Nonetheless, although the auditor's use of a grant to exercise methodology resulted in a fairer result for New York's treasury since the stock options and earnings bonus units were granted by Exxon to petitioner when he was employed by Exxon in New York, the auditor's use of such methodology was based upon a reversal in policy and *not* the application of the old policy. Furthermore, "fairness" was not a concern on the part of the Division or the State Tax Commission when the year of exercise methodology was applied in ***Matter of Christensen, supra***, as discussed in Conclusion of Law "O", and

the invocation of the need for "fairness" to justify the use of the grant to exercise methodology, when the result is a higher New York tax bill, rings hollow.

R. In light of the above analysis, that the auditor's use in 1994 of the grant to exercise period for allocating petitioner's compensation from stock options and earnings bonus units represented a reversal of the Division's prior policy of allocating such income by the year of exercise methodology, the auditor's use of the grant to exercise methodology was improper because it was implemented without prior public notice. TSB-M-95-(3)I, as noted in Finding of Fact "37", was not issued until November 21, 1995. This memorandum represented the first public notice of the new methodology and may not be applied retroactively to petitioner (***cf., Matter of Friesch-Groningsche Hypotheek Bank Realty Credit Corporation***, Tax Appeals Tribunal, December 28, 1990). Its retroactive application by the Division to petitioner is properly viewed as arbitrary and capricious (***see, Howard Johnson Co. v. State Tax Com'n***, 65 NY2d 726, 492 NYS2d 11). Consequently, the Division may not assert additional tax due against petitioner for 1991.

S. There is no evidence that petitioner's rights against selective enforcement were violated by the Division. Mr. Rawl was not targeted by the Division when the auditor chose to apply the grant to exercise methodology to his 1991 income from stock options and earnings bonus units. Nonetheless, this unsubstantiated speculation on the part of petitioner would have been nipped in the bud if the Division had given public notice of the change in policy before it implemented the new policy.

T. In light of the above analysis, the issues designated "V" and "VI" at the beginning of this determination are rendered moot.

U. The petition of Lawrence G. Rawl is granted, and the Notice of Deficiency dated November 14, 1994 is cancelled, and the Division is directed to recalculate petitioner's 1989 tax liability based upon the decrease of two days in petitioner's Exxon workdays in New York, as noted in Finding of Fact "8", and to refund petitioner's overpayment of tax for 1989 plus interest.

DATED: Troy, New York

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ADMINISTRATIVE LAW JUDGE