STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
E. RANDALL STUCKLESS AND JENNIFER OLSON	:	DETERMINATION DTA NO. 819319
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1997 and 1998.	:	

Petitioners, E. Randall Stuckless and Jennifer Olson, 68 Partridge Hill, Honeoye Falls, New York 14472, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1997 and 1998.

On September 8 and 22, 2003, respectively, petitioners by their representative, Arnold R. Petralia, Esq., and the Division of Taxation by Mark F. Volk, Esq. (Barbara J. Russo, Esq., of counsel), waived a hearing and agreed to submit this matter for determination based on documents and briefs to be submitted by January 23, 2004, which commenced the six-month period for the issuance of this determination. After review of the evidence and arguments presented, Thomas C. Sacca, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether income received by petitioners from the exercise of stock options granted during petitioner E. Randall Stuckless's New York employment is subject to tax as New York source income, where the exercise occurred while petitioner was a nonresident.

II. Whether the Division of Taxation properly allocated the stock option income based on days worked in and out of the State.

III. Whether reasonable cause exists for the abatement of the penalties imposed for failure to file a return and for negligence.

FINDINGS OF FACT

1. On October 21, 2002, following an audit, the Division of Taxation ("Division") issued to petitioners, E. Randall Stuckless and Jennifer Olson,[1] a Notice of Deficiency which asserted additional tax due for the year 1997 of $13,735.73 and for the year 1998 of $35,084.23, for a total amount due of $48,819.96. The Notice of Deficiency also asserted penalty and interest due for each of the years at issue.

2. The Division's audit of petitioner for the years 1997 and 1998 focused on the difference between petitioner's Federal adjusted gross income (AGI) and New York source income as reported. Specifically, the Division increased the amount of petitioner's income from Microsoft Corporation ("Microsoft") allocable to New York for each of the years at issue. The method used by the auditor to apportion the gain realized on the exercise of incentive stock options ("ISO") to New York was based on the number of New York working days from the option grant date to the exercise date compared to the total number of days worked both in and out of New York for the same period. The Division made no adjustments to petitioner's reported Federal AGI.

The options exercised in 1997 were granted in 1991, when petitioner was a resident of New York. The Division allocated the proceeds from the stock options from the date of grant, November 4, 1991, to the dates of exercise. The options that were exercised in 1998 were

[1] Jennifer Olson is a petitioner in this matter solely because she filed a joint New York nonresident and part-year resident income tax return with her spouse, E. Randall Stuckless, for 1998. All of the income at issue was paid to E. Randall Stuckless. Accordingly, unless otherwise indicated, all references to petitioner herein shall refer to E. Randall Stuckless.

granted in 1992, also when petitioner was a resident of New York. The Division allocated the proceeds from the stock options from the date of grant, July 7, 1992, to the dates of exercise. The Division determined petitioner's residency allocation for the relevant years and periods, as follows: 1992, 1993, 1994, 1995, and January 1, 1996 through September 1, 1996, when petitioner moved out of New York State, 100% allocation; September 1, 1996 through December 31, 1996, 1997 and January 1, 1998 through July 5, 1998, 0% allocation; and July 6, 1998, when petitioner moved back to New York State, through December 31, 1998, 100% allocation.

3. Petitioner did not file a 1997 New York return. On his Federal return for that year petitioner reported $281,141.00 in adjusted gross income, including $292,454.00 in wage income, which corresponds to the amount of wage income reported by Microsoft to have been paid to petitioner in 1997. On audit the Division determined that $202,351.92 of this Microsoft income was allocable to New York and asserted New York tax due of $13,735.73.

4. On his 1998 New York return petitioner reported New York adjusted gross income of $60,781.00 and Federal adjusted gross income of $709,866.00. During the tax year 1998, Microsoft paid petitioner $739,155.00 in wage income. On audit, the Division determined that $526,799.00 of this Microsoft income was allocable to New York and asserted New York tax due of $39,153.23.

5. E. Randall Stuckless worked for Microsoft during the period in issue and is currently employed by Microsoft.

6. Microsoft granted Mr. Stuckless incentive stock options to buy Microsoft stock on November 4, 1991 and July 7, 1992. The Stock Option Plan which granted the ISO's provided as its purpose as follows:

> The purposes of this Stock Option Plan are to attract and retain the best available personnel for positions of substantial responsibility, to provide additional

> incentive to such individuals, and to promote the success of the Company's business by aligning employee financial interests with long-term shareholder value.

The plan further provided that options were only to be granted to employees, and directors were not eligible to participate in the plan unless they were full-time employees. The per share exercise price was based upon the number of shares owned by the employee at the time of the grant of the ISO. Where the employee owned shares representing more than 10% of the voting power of all classes of shares of Microsoft, the per share exercise price was not to be less than 110% of the fair market value per share on the date of the grant. For any other employee, the per share exercise price was not to be less than 100% of the fair market value per share on the date of the grant.

In the event of termination of an option holder's continuous status as an employee, the option holder was required to exercise the stock options within three months of termination. However, the plan provided for the increase of the period for exercising the stock option following termination where termination of employment occurred as a result of death (6 months), total and permanent disability (12 months) or under any other circumstances where the Board of Directors deemed an extension to be appropriate, as long as the extension did not exceed the term of the option as originally issued.

In addition, the plan provided that the option may not be sold, pledged, assigned, hypothecated, transferred or disposed of in any manner other than by will or by the laws of descent or distribution and may be exercised, during the lifetime of the option holder only by the option holder provided that the Board may permit further transferability, on a general or specific basis, and may impose conditions and limitations on any permitted transferability. The plan

further provided that an option holder's right to exercise his or her stock option generally vests in increments over time.

7. Mr. Stuckless was a New York State resident and worked in New York when the options were granted.

8. Jennifer Olson was a resident of New York State in 1991 and 1992.

9. The options were granted under a document entitled "Microsoft Corporation 1991 Stock Option Plan."

10. Mr. Stuckless moved to Seattle, Washington on September 1, 1996.

11. Mr. Stuckless resided in Seattle, Washington until he moved back to New York on or about July 4, 1998.

12. From September 1, 1996 to July 4, 1998, petitioners were nonresidents of New York.

13. On or after July 5, 1998, petitioners were New York State residents.

14. At various times while a Washington resident, Mr. Stuckless exercised a portion of the ISO's and sold the option stock. Each ISO exercise was simultaneous with a sale of the underlying stock. Mr. Stuckless also exercised options, and sold stock, while residing in New York, but these transactions are not at issue in this proceeding.

15. ISO stock sold between September 1, 1996 and July 4, 1998 was sold while Mr. Stuckless was a resident of the State of Washington. Stock sales after July 4, 1998 occurred after he had moved back to New York and was a New York resident.

16. Petitioners concede that income from the ISO exercise and sales occurring after July 4, 1998 is taxable to New York State.

17. The ISO's that were exercised while Mr. Stuckless resided in the State of Washington, the quantity, grant date, grant number, grant price, market price as well as the gain per New York and allocation to New York as determined on audit are as follows:

Exercise and Sales Date	Quantity	Grant Date	Grant #	Grant Price	Market Price	Gain per New York	Alloc. to NY per Audit
1/27/97	1600	11/4/91	014321	1.896	12.0000	16,166.64	15,961.08
4/17/97	3200	11/4/91	014321	1.896	12.3906	32,583.36	32,076.73
4/29/97	2400	11/4/91	014321	1.896	14.8125	30,999.96	29,186.84
5/8/97	1600	11/4/91	014321	1.896	14.3906	19,991.68	18,728.90
6/3/97	1200	11/4/91	014321	1.896	15.2656	16,043.76	14,851.17
7/11/97	1200	11/4/91	014321	1.896	16.1563	17,112.48	15,546.09
7/17/97	1200	11/4/91	014321	1.896	18.5234	19,953.12	18,076.95
9/17/97	800	11/4/91	014321	1.896	17.3046	11,870.84	10,446.34
10/8/97	400	11/4/91	014321	1.896	17.3046	6,163.54	5,370.21
11/4/97	600	11/4/91	014321	1.896	16.7734	8,926.56	7,746.92
11/10/97	400	11/4/91	014321	1.896	16.3906	5,797.92	5,015.24
11/18/97	600	11/4/91	014321	1.896	16.8438	8,968.74	7,727.63
12/2/97	800	11/4/91	014321	1.896	18.0730	12,939.56	11,091.05
12/17/97	800	11/4/91	020478	2.125	17.4765	12,281.24	10,526.78
1/7/98	800	7/792	020478	2.125	16.0225	11,118.76	8,313.89
1/12/98	400	7/7/92	020478	2.125	16.1719	5,618.75	4,191.84
1/28/98	800	7/7/92	020478	2.125	18.5406	13,212.52	9,776.08
2/27/98	400	7/7/92	020478	2.125	21.4530	7,731.26	5,632.04
3/10/98	400	7/7/92	020478	2.125	20.1563	7,212.50	5,227.21
3/27/98	400	7/7/92	020478	2.125	22.0313	7,962.50	5,716.37
4/15/98	800	7/7/92	020478	2.125	22.6875	16,450.00	11,699.35

4/28/98	1200	7/7/92	020478	2.125	22.7030	24,693.78	17,449.57
6/26/98	1000	7/7/92	020478	2.125	25.9375	23,812.50	16,337.06

The market price at which each option stock sale was made is based upon a printout from Microsoft entitled "Exercise History for E. Randall Stuckless."

18. The market price of Microsoft stock when petitioners left New York on September 1, 1996, adjusted for stock splits, was $7.710938 per share. This is based on the NASDAQ Exchange close for September 3, 1996, as September 1, 1996 was a Sunday and September 2, 1996 was Labor Day. As the stock market was closed on both days, the first trading day after September 1, 1996 would have been September 3, 1996.

As the above table indicates, the option price for the 1991 ISO's was $1.896 per share except for the one granted on 12/17/97 which was $2.125 per share, the same option price for the ISO's granted in 1992. The 1997 ISO's were exercised and stock sold at prices ranging between $12.00 and $18.00 per share. The ISO's exercised between January and July 4, 1998 were at prices ranging between $16.00 and $26.00 per share.

The total amount of appreciation for the stock options exercised in 1997 as of September 1, 1996 was $97,508.00, while the Division's method of allocation resulted in a gain on the exercise of these stock options of $202,352.00. For the stock options exercised in 1998, the amount of appreciation as of September 1, 1996 was $34,633.00, while the Division's method of allocation resulted in a gain of $84,343.00. The cause of the difference in the amounts of the gain between that computed as of September 1, 1996 and the Division's method of allocation is that the appreciation in Microsoft stock after September 1, 1996 was greater than the appreciation of the stock between the date of grant and September 1, 1996.

19. Petitioners did not file a New York State income tax return for 1997, and filed a joint Nonresident and Part-Year Resident Income Tax Return for the year 1998. During each of the years at issue, petitioner received income from Microsoft which was reported by Microsoft on form W-2.

20. On or about October 28, 1997, petitioners separated, and were divorced on or about May 28, 1999.

CONCLUSIONS OF LAW

A. Tax Law § 601(e) imposes a personal income tax for each taxable year on a nonresident individual's taxable income which is derived from sources within New York State. Section 631(a) of the Tax Law provides that the New York source income of a nonresident individual includes the net amount of items of income, gain, loss and deduction entering into the individual's Federal adjusted gross income derived from or connected with New York sources. Section 631(b)(1)(B) indicates that items of income, gain, loss and deduction derived from or connected with New York sources include those items attributable to a business, trade, profession or occupation carried on in New York State. In determining New York source income, section 132.4(b) of the Personal Income Tax Regulations directs that a nonresident individual, rendering personal services as an employee, include the compensation for personal services entering into the individual's Federal adjusted gross income to the extent that the individual's services were rendered in New York State. Where the personal services are performed both within and without New York State, the portion of the compensation attributable to the services performed within New York State must be determined in accordance with sections 132.16 through 132.18 of the regulations.

B. Section 132.18 of the regulations provides as follows:

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.

C. To prevail in the instant matter, petitioner must initially show that the income in question was not secured or earned pursuant to activities connected with or derived from New York sources (***see, Matter of Laurino***, Tax Appeals Tribunal, May 20, 1993). In making this determination, the controlling factor is the consideration given by petitioner in exchange for the right to the income at issue (***Matter of Laurino, supra, citing Matter of Halloran,*** Tax Appeals Tribunal, August 2, 1990). In other words, "it is necessary to examine what petitioner gave up in exchange for the right to the income at issue" (***Matter of Haas***, Tax Appeals Tribunal, April 17, 1997). Where the consideration has no connection to New York, the income will not be subject to tax by the State (***Matter of Donohue v. Chu***, 104 AD2d 523, 479 NYS2d 889).

The stock options awarded to petitioner on November 4, 1991 and July 7, 1992 under the Stock Option Plan were secured or earned through petitioner's Microsoft employment and were therefore properly considered New York source income for the years at issue. The Plan provided that its purpose was to attract and *retain* the best available personnel for positions of substantial authority and "to *provide additional incentive* to such individuals by aligning employee financial interests with long-term shareholder value (emphasis added)." Such language is indicative that

awards under the plan were intended as compensation for services rendered to the company. Furthermore, the Court of Appeals has held that employee stock options for either past services or incentive for future services are compensation attributable to the employee's "business, trade, profession or occupation carried on in New York " (Tax Law § 632[b][1]; ***see***, ***Matter of Michaelsen v. New York State Tax Commn.***, 67 NY2d 579, 505 NYS2d 585). In ***Michaelsen***, the Court of Appeals held that stock options are compensation under the Tax Law. ***Michaelsen*** is controlling in the instant matter and petitioner's contention that awards under the Stock Option Plan were not payment for services rendered and therefore not subject to New York income tax is rejected.

Additionally, petitioner's argument that his rights did not vest until he exercised the options while a resident in Washington in 1997 and 1998 is not supported by the evidence in the record. The Stock Option Plan provides with regard to "vesting" that "[a]n option holder's right to exercise his or her stock option generally vests in increments over time. Vesting schedules are set by the Board, and may vary among option holders. Please refer to your stock option grant agreement to determine your vesting schedule." As the stock option grant agreement is not in the record of this matter, the Stock Option Plan's provision that vesting occurs over time supports the conclusion that while an employee in New York State prior to his move to Washington, petitioner had a vested interest in the ISO's granted by Microsoft in 1991 and 1992.

D. In 1986, the Court of Appeals decision in ***Matter of Michaelsen v. New York State Tax Commission*** (***supra***) held 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 and therefore properly subject to New York personal income tax.

The Court of Appeals in ***Michaelsen*** looked to Federal treatment of employee stock options for guidance in determining proper valuation of the compensation attributable to certain employee stock options under Tax Law § 632, stating:

> If an option, by virtue of its transferability, has a **readily ascertainable fair market value** when it is granted, it will be valued at the time it is received by the employee (Internal Revenue Code § 83[a]; Treas Reg [26 CFR] § 1.83-7[a]). An option granted, as here, pursuant to a qualified employee stock option plan is not transferable, however (Internal Revenue Code § 422[b][6]), and cannot have a **readily ascertainable fair market value** when it is granted (Treas Reg [26 CFR] § 1.83-7[b][1],[2]). Gain derived from these latter options is *realized* when the option is exercised; the option is valued by subtracting the option price from the fair market value of the stock when the option is exercised (Treas Reg [26 CFR] § 1.83-7[a]). This gain is characterized by Federal authorities as compensation for services performed (***Commissioner v. LoBue***, 351 US 243, 247; Treas Reg [26 CFR] 1.422-1[b][3], example [2]). Although the gain on qualified stock options, such as the options granted to petitioner, is *realized* at the time the options are exercised, the gain is not *recognized* until the stock is disposed of. Thus, although under Federal law both the gain on the appreciation of the stock after it is purchased and the compensation derived from the exercise of the option are actually *recognized* when the stock is sold, there are two realization events reflecting the taxation of two distinct accretions to income (***id.***, 505 NYS2d at 587- 588; italics in original, bold emphasis added).

The ***Michaelsen*** Court went on to dismiss taxing as compensation only the difference between the fair market value of the stock on the date the option is first exercisable and the option price, noting that such a taxing scheme would differ from Federal law and would leave much of the compensation to the employee untaxed. The Court noted that the value of an option on the date it became exercisable is greater than the difference between the option price and the fair market value as of that date and is properly taxed as the New York compensation of a nonresident. The Court reasoned, however, that:

> Because the option [at issue] is not transferable (Internal Revenue Code [former] § 422[b][6]), this extra value cannot be adequately measured on the date the

> option becomes exercisable (Treas Reg [26 CFR] § 1.83-7[b][2]). Thus, in conformity with Federal law, we 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. Accordingly, . . . this income is taxable in New York under Tax Law § 632(b)(1)(B) (***id.***, 505 NYS2d at 588, 589; emphasis added).

The Court's holding in ***Michaelsen*** relied on Federal tax law and the Court used the phrase "readily ascertainable fair market value" in the context of Internal Revenue Code § 83 and the Commissioner's regulations promulgated thereunder. Section 1.83-7(b) of the Commissioner's regulations (Treas Reg [26 CFR] § 1.83-7[b]) define "readily ascertainable" for purposes of Internal Revenue Code § 83. Pursuant to such regulations, an option that is not actively traded on an established market and is not transferable by the owner of the option does not, by definition, have a readily ascertainable fair market value (Treas Reg [26 CFR] § 1.83-7[b][2]). The options at issue were not actively traded and were not transferable. Accordingly, such options did not have a "readily ascertainable fair market value" within the meaning of the Court's holding in ***Michaelsen*** and the Federal statute and regulation upon which it relies. Internal Revenue Code § 83 and section 1.83-7(b) of the Commissioner's regulations (Treas Reg [26 CFR] § 1.83-7[b]) did not change from the time of the ***Michaelsen*** decision through the period at issue. Contrary to petitioner's assertion, then, the ***Michaelsen*** decision is applicable to the matter at hand. Accordingly, pursuant to ***Michaelsen***, the Division properly valued the options at issue as of the date of exercise.

E. The Technical Services Bureau of the Taxpayer Services Division issued, on November 21, 1995, a memorandum, TSB-M-95-(3)I, 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." 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 from 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.

TSB-M-95(3)1 was issued by the Division in response to the ***Michaelsen*** decision, and was based upon Tax Law § 631(c) and 20 NYCRR 132.18, which provide that income earned by a nonresident employee is to be allocated based upon the number of days the employee worked inside and outside the state. The memorandum explains that where stock options are granted to a taxpayer in New York and the taxpayer subsequently has a change of residence outside New York State, the amount of any gain includable in New York source income is limited to the appreciation in the value of the stock from the date of grant to the date of exercise, and any allocation is based on days worked inside and outside the state determined as if the taxpayer were a nonresident from the time the option was granted until it was exercised. The Technical

Services Memorandum represents a reasonable interpretation of the ***Michaelsen*** decision, the Tax Law and the Regulations as they apply to nonresident income in the form of stock options earned while the taxpayer was a resident of New York State. An interpretation or construction of a statute by an agency charged with its administration is to be upheld if it is not irrational or unreasonable (***Matter of Lumpkin v. Dept. of Social Services***, 45 NY2d 351, 408 NYS2d 421).

Petitioner's argument that he be treated as if his employment terminated on the date he moved to Washington and that the fair market value of the stock on the date he moved out of New York be used to determine the gain realized are inconsistent with the purpose of the Tax Law and regulations, which attempt to allocate to New York the compensation derived from New York employment. They are also inconsistent with the decision in ***Michaelsen***, which held that the gain derived from stock options is realized when the option is exercised, and valued by subtracting the option price from the fair market value of the stock at the time of exercise. Although petitioner left New York prior to exercising the stock options, he continued to benefit from the appreciation in the value of the options granted, and therefore earned, while a New York employee. At the time of exercising the options, petitioner realized a gain which was secured and earned from New York sources.

The Technical Service Bureau Memorandum recognizes that a gain from the exercise of stock options is derived from New York sources and represents compensation to the employee for the period of employment with the company granting the options. Had petitioner terminated his employment with Microsoft, the allocation period would have ended on the date employment ceased. However, he remained an employee of Microsoft, and allocating the gain derived from the exercise of the stock options over the compensable period (in this case, since employment with Microsoft continued past the date of exercise, from the date the options were granted to the

date the options were exercised), is consistent with petitioner's continued employment with Microsoft.

F. Petitioner contends that TSB-M-95(3)I failed to comply with the procedural requirements for its publication as stated in the State Constitution, State Administrative Procedure Act and the State Executive Law. Since the memorandum was not duly promulgated and filed in accordance with New York law, petitioner asserts, it must be deemed a legal nullity.

Technical Services Bureau Memoranda are statements of an informational nature issued to advise taxpayers of significant changes in the law, to disseminate the Division's interpretation of the Tax Law, and to notify the public of current audit policy and guidelines (***see,*** Developing and Communicating Interpretations of the Tax Laws: A Report to the Governor and the Legislature Reviewing Department of Taxation and Finance Policies and Practices, March 1989, at 20). As such, they clearly come within the exception of "forms and instructions, interpretative statements and statements of general policy which in themselves have no legal effect but are merely explanatory" specifically excluded from the formal promulgation requirements governing rulemaking by administrative agencies (State Administrative Procedure Act § 102[2][b][iv]; ***see, Matter of Hawkes v. Bennett***, 155 AD2d 766, 547 NYS2d 704; ***Leichter v. Barber***, 120 AD2d 776, 501 NYS2d 925). To be sure, because TSB-M-95(3)I does not meet the statutory notice and filing requirements, it cannot, in and of itself, purport to have any definitive legally binding effect. However, to the extent that the memorandum states a correct and straightforward interpretation of the governing statute, the Technical Services Bureau Memorandum constitutes an effective administrative vehicle for informing taxpayers of the position of the Division. Although petitioner maintains otherwise, the Division is not required to promulgate regulations regarding its treatment of stock options received by nonresidents and part-year residents (***Matter***

of Friesch-Groningsche Hypotheek Bank Realty Credit Corp. v. Tax Appeals Tribunal, 185 AD2d 466, 585 NYS2d 867, ***lv denied*** 80 NY2d 761, 592 NYS2d 670; ***Matter of Reynolds, Bogoni, Kelly & Urich***, Tax Appeals Tribunal, March 9, 1995). The memorandum was an appropriate method to explain the Division's policy on the treatment of stock options, and it adequately advised taxpayers of that policy. (***See***, ***Matter of Friesch-Groningsche Hypotheek Bank Realty Credit Corp.***, Tax Appeals Tribunal, December 28, 1990, ***confirmed***, ***supra***.)

G. Petitioner's argument that there is no compensation until the incentive stock options are exercised because the ISO's terminate when employment is terminated is rejected. Initially it is noted that the options terminate three months after the termination of employment, providing the option holder an opportunity to exercise the options after termination of employment. The Stock Option Plan also provides that an option holder's right to exercise his or her stock option generally vests in increments over time. More importantly, incentive stock options have been held to be compensation and are taxable as such, with the amount of compensation to the employee being measured by the difference between the option price and the market value of the shares at the time the option is exercised (***Commissioner v. LoBue***, ***supra***; ***Matter of Michaelsen v. New York State Tax Commission, supra***). Furthermore, in determining whether the compensation is connected to New York, it is necessary to examine the employment activities of the nonresident during the period in which the benefit was actually secured or earned, not when the benefit was received or realized (***Matter of Halloran***, Tax Appeals Tribunal, August 2, 1990). As the ISO's were granted while petitioner was employed by Microsoft in New York, it is clear that the options were earned by petitioner's New York employment, and thus properly taxable to New York as compensation for services connected with New York.

H. Petitioner claims that the Division is collaterally estopped from arguing that the allocation method provided in TSB-M-95(3)I is applied consistently to all similarly situated taxpayers, creating in this case a discriminatory application because this same issue was addressed in a previous hearing before an administrative law judge in the Division of Tax Appeals. This claim is rejected. Tax Law § 2010(5) provides that administrative law judge determinations "shall not be cited" or "be given any force or effect in any other proceedings." The use of collateral estoppel to preclude a party from raising an issue based upon a prior ALJ determination necessarily cites that prior determination and necessarily gives such determination "force" and "effect." Tax Law § 2010(5) thus precludes the application of collateral estoppel herein.

As no evidence of discriminatory application of TSB-M-95(3)I was presented by petitioner, this claim is rejected.

I. The Division assessed penalties for failure to file a return pursuant to Tax Law § 685 (a)(1)(A) for 1997 and for negligence pursuant to Tax Law § 685(b)(1) and (2) for 1997 and 1998. Petitioner claims that reasonable cause exists for the abatement of these penalties because it was not foreseeable by him that a portion of his gain on ISO stock sales while a resident of Washington would be treated as New York source income. However, it must be noted that the Division provided public notice of TSB-M-95(3)I on November 21, 1995, several years prior to the date that petitioner was required to file his 1997 and 1998 New York State personal income tax returns. Having been placed on notice of the Division's policy with regard to the treatment by nonresidents when exercising stock options granted while employed in New York, petitioner's claim of reasonable cause based on a lack of knowledge as to the tax treatment of the stock options is rejected.

J. The petition of E. Randall Stuckless and Jennifer Olson is denied, and the Notice of Deficiency issued October 21, 2002 is sustained.

DATED: Troy, New York
July 8, 2004

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE