STATE OF CALIFORNIA
FRANCHISE TAX BOARD

FTB Publication 1004

Stock Option Guidelines

Contents

A Introduction

An employee stock option is the right or privilege granted by a corporation to purchase the corporation's stock at a specified price during a specified period.

Stock option plans that meet the requirements of Internal Revenue Code (IRC) sections 421-424 are referred to as *statutory* stock options; those that do not are referred to as *nonstatutory* stock options and are governed by IRC section 83.

Statutory stock options consist of incentive stock options and employee stock purchase plans. Nonstatutory stock options are all other options.

California law conforms to federal law concerning the taxation of statutory and nonstatutory stock options. Get IRS Pub. 525, *Taxable and Nontaxable Income*, for more information regarding the taxation of stock options.

In addition to these stock options, California Revenue and Taxation Code (R&TC) section 17502 provides for California qualified stock options.

This publication provides information on the taxation of the various types of stock options and how you determine what stock option income is taxable by California when you change your residency status. Get FTB Pub. 1031, *Guidelines for Determining Resident Status*, for information to help you determine your residency status.

B Key Terms Used in This Publication

Grant date:	The date the company grants the option to you
Option price:	The price you will pay for the stock
Exercise date:	The date you purchase the stock at the option price
Qualifying disposition:	A disposition that meets the following IRC sections 422 or 423 holding period requirements: • No sale of the stock within 2 years from the grant date of the option • No sale of the stock within 1 year after the date you exercise the option
Disqualifying disposition:	A disposition that does not meet the holding period requirements of IRC sections 422 or 423

C Nonstatutory Stock Options

Generally, you recognize taxable wage income upon the exercise of a nonstatutory stock option. The taxable wage income is the difference between the fair market value of the stock on the exercise date and the option price.

If you paid tax on this wage income to California and another state, you may be allowed a credit for taxes paid on this double-taxed income. Get California Schedule S, *Other State Tax Credit*, for more information.

Change of Residency to California (Move-in)

If you are granted a nonstatutory stock option while a nonresident of California and later exercise the option while a California resident, the difference between the fair market value of the shares on the exercise date and the option price is taxable by California because you are a resident of this state when the income is recognized (*Appeal of Earl R. and Alleene R. Barnett,* California State Board of Equalization, October 28, 1980).

Example 1 – On March 1, 1997, while a resident of Michigan, your employer grants you a nonstatutory stock option. On June 1, 2001, you retire and permanently move to California. On August 1, 2001, you exercise your option.

Determination: Because you are a California resident when the nonstatutory stock option income is recognized, the difference between the fair market value of the shares on August 1, 2001, and the option price is wage income taxable by California. If you also paid tax to Michigan, you are allowed a credit against California taxes paid to Michigan on this double-taxed income.

Change of Residency from California (Move-out)

If you are granted a nonstatutory stock option while a California resident and later exercise the option while a nonresident, the character of the stock option income recognized is compensation for services rendered. The income is taxable by California to the extent you performed services in this state (*Appeal of Charles W. and Mary D. Perelle*, California State Board of Equalization, December 17, 1958).

All service performed within California:

If you performed services for the corporation entirely within California but exercise the option after terminating employment and becoming a nonresident, the difference between the fair market value of the stock on the exercise date and the option price has a source in California, where you performed the services.

Example 2 – On February 1, 1998, while a resident of California, your company granted you nonstatutory stock options. You performed all of your services in California from February 1, 1998, to May 1, 2001, the date you left the company and permanently moved to Texas. On June 1, 2001, you exercised your nonstatutory stock options.

Determination: The difference between the fair market value of the shares on June 1, 2001, and the option price is characterized as compensation for services having a source in California, the state where you performed all of your services.

Services performed within and outside California:

If you performed services both within and outside California you must allocate to California that portion of total compensation reasonably attributed to services performed in this state (Title 18, Cal. Code Regs. Section 17951-5).

One reasonable method is an allocation based on the time worked. The period of time you performed services includes the total amount of time from the grant date to the exercise date (or the date your employment ended, if earlier).

The allocation ratio is:

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

Income taxable by California = Total stock option income x Allocation ratio

Example 3 – On November 1, 1997, while a resident of California, your company granted you nonstatutory stock options. On November 1, 2001, you left the company and permanently moved to Florida. From November 1, 1997, through November 1, 2001, you worked for the company a total of 700 days in California and 300 days in other states. On December 1, 2001, you exercised your option.

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Determination: The difference between the fair market value of your shares on December 1, 2001, and the option price is stock option income characterized as compensation for services. The total workdays from grant date to exercise date equal 1,000 workdays (700 California workdays + 300 other state workdays). Your allocation ratio is .70 (700 California workdays ÷ 1,000 total workdays). Therefore, 70 percent of your total stock option income is taxable by California.

D Incentive Stock Options

Qualifying Disposition

You do not include any amount in income when an incentive stock option is granted to you or when you exercise the option. You recognize capital gain or loss when you sell the stock if the holding period requirements under IRC section 422 are met.

Disqualifying Disposition

A disqualifying disposition results when you sell the stock before meeting the holding period requirements. The difference between the fair market value (or the sale price, if lower) of the stock on the exercise date and the option price is treated as ordinary income (wages). The increase between the stock's fair market value (FMV) on the sale date and the exercise date is a capital gain [Proposed Treasury Regulation 1.422A-1(b)(3)].

Incentive Stock Option Tax Treatment Summary Table

Disposition Type	Computation	Character
Qualifying disposition:	Sales price minus option price	Capital gain
Disqualifying disposition: Sales price > FMV on exercise date	FMV on exercise date minus option price Sales price minus FMV on exercise date	Ordinary income Capital gain
Disqualifying disposition: Sales price < FMV on exercise date	Sales price minus option price	Ordinary income

If you paid tax on the wage income to California and another state, you may be allowed a credit for taxes paid on this double-taxed income. Get California Schedule S, *Other State Tax Credit*, for more information.

Alternative Minimum Tax

For federal and California alternative minimum tax (AMT), you must treat stock acquired through the exercise of an incentive stock option as if the option were a nonstatutory stock option. This means that you must generally include as an AMT adjustment, the difference between the fair market value of the stock on the exercise date and the option price in the year the option is exercised.

Get California Schedule P (540), *Alternative Minimum Tax and Credit Limitations – Residents* or California Schedule P (540NR) *Alternative Minimum Tax and Credit Limitations - Nonresidents and Part-Year Residents* for further information regarding California AMT.

Increase your AMT basis in the stock you acquired from exercising your incentive stock option by the amount of the adjustment. You may be allowed an AMT credit in a subsequent year. Get California Form 3510, *Credit for Prior Year Alternative Minimum Tax, Individuals or Fiduciaries*, for more information.

No AMT adjustment is required if you dispose of the stock in the same year you exercise the option.

Change of Residency to California (Move-in)

Qualifying Disposition

If you exercise an incentive stock option while a nonresident of California and later sell the stock in a qualifying disposition at a gain while a California resident, the resulting capital gain is taxable by California because you are a California resident when the stock is sold.

Example 4 – On February 1, 1997, while a resident of Ohio, your company grants incentive stock options to you. On April 1, 2000, you exercise your options. On September 1, 2001, you permanently move to California and sell your stock on October 15, 2001, for a gain.

Determination: Because you were a California resident when you sold the stock, the resulting capital gain is taxable by California.

Disqualifying Disposition

If you exercise an incentive stock option while a nonresident of California and later sell the stock in a disqualifying disposition while a California resident, the resulting wage income and capital gain (if applicable) are taxable by California because you are a California resident when the stock is sold.

Example 5 – On February 1, 1997, while a resident of Ohio, your company grants incentive stock options to you. On April 1, 2001, you exercise your options. On June 1, 2001, you permanently move to California and sell your stock on October 1, 2001. The sale price is greater than the fair market value of the stock on the exercise date.

Determination: The resulting wage income and capital gain is taxable by California because you were a California resident on the date you sold the stock. If you also paid tax to Ohio on the wage income, you are allowed a credit for taxes paid on this double-taxed income. (Get the California Schedule S for more information.)

Change of Residency From California (Move-out)

Qualifying Disposition

If you exercise an incentive stock option while a California resident or a nonresident and later sell the stock in a qualifying disposition while a nonresident, the income is characterized as income from the sale or disposition of intangible personal property having a source in your state of residence at the time you sold the stock. Accordingly, you are not subject to regular tax by California even though the services that gave rise to the grant may have been performed in this state.

An AMT adjustment must be made in the year you exercise the incentive stock option. The source of the adjustment is determined in the same manner as income from the exercise of nonstatutory stock options for regular tax purposes.

Example 6 – On March 1, 1998, you were granted an incentive stock option. On March 1, 2000, you exercised your option. You were a California resident and performed all of your services in California from the grant date to the exercise date. On February 1, 2001, you permanently moved to Illinois. On June 1, 2001, you sold your stock at a gain.

Determination: You must make an AMT adjustment on your 2000 California return because you did not dispose of the stock in the year you exercised your option. The capital gain is not taxable by California in 2001 because you were a nonresident of California when you sold the stock.

Disqualifying Disposition

If you exercise an incentive stock option while a California resident or a nonresident and dispose of the stock in a disqualifying disposition while a nonresident, the transaction is treated as if you exercised a nonstatutory stock option. The difference between the option price and the fair market value on the exercise date is wages [Sun Microsystems, Inc., 69 TCM 1884 (1995)]. The source of the income is where you performed services between the grant date and the exercise date.

No AMT adjustment is required if you dispose of the stock in the same year you exercise the option. However, if the stock is disposed of in a later year, then an AMT adjustment must be made in the year you exercised your incentive stock option. The source of the alterative minimum tax adjustment is determined in the same manner as is income from the exercise of a nonstatutory stock option for regular tax purposes.

Example 7 – You were a resident of California and worked for X Company. You performed all of your services in California during your entire career. On April 1, 1998, you were granted an option to purchase stock under your company's incentive stock option plan. The option price on April 1, 1998, was $10 per share. On April 1, 2000, while still living and working in California, you exercised your option to purchase 30,000 shares of your company's stock. The fair market value on April 1, 2000, was $50 per share. On July 1, 2000, you retired and permanently moved to Florida. On October 15, 2000, you sold the 30,000 shares for $35 per share.

Determination: The character of the income from the disqualifying disposition is wages. Because you performed all your services in California between the grant date and the option exercise date, 100 percent of the income will be wages from a California source.

FMV of stock, date of sale:	$ 1,050,000	(30,000 shares @ $35* per share)
Less option price, date of grant:	- 300,000	(30,000 shares @ $10 per share)
Wage income, CA source:	$ 750,000	

*The sale price of $35 is used to compute wage income because it is less than the exercise price of $50. There was no increase in the share's fair market value from the exercise date to the sale date, thus there is no capital gain.

You do not need to make an AMT adjustment in tax year 2000 because you disposed of the stock in the same year you exercised your option.

Example 8 – Assume the same facts as Example 7, except you sold the stock on March 15, 2001, when the fair market value of the stock was $60 per share.

Determination:

Tax Year 2000

You must make an alterative minimum tax adjustment in tax year 2000 because you did not dispose of the stock in the same year you exercised your option. Because you performed 100 percent of your services in California, 100 percent of the AMT adjustment will have a California source. The adjustment is determined as follows:

FMV of stock, date of exercise:	$ 1,500,000	(30,000 shares @ $50 per share)
Less option price:	- 300,000	(30,000 shares @ $10 per share)
AMT adjustment, CA source:	$ 1,200,000	

Your AMT basis in the stock is determined as follows:

Option price:	$ 300,000
Plus AMT adjustment:	1,200,000
AMT basis:	$1,500,000

Tax Year 2001

Wage income from a California source is determined as follows:

FMV of stock, date of exercise:	$ 1,500,000	(30,000 shares @ $50 per share)
Less option price:	- 300,000	(30,000 shares @ $10 per share)
Wage income, CA source income:	$ 1,200,000	

The increase in the fair market value of the stock from the exercise price of $50 to the sale price of $60 is characterized as capital gain. The capital gain has a source in Florida, your state of residence when you sold the stock.

FMV of stock, date of sale:	$ 1,800,000	(30,000 shares @ $60 per share)
Less FMV of stock, date of exercise:	- 1,500,000	(30,000 shares @ $50 per share)
Capital gain, FL source income:	$ 300,000	

You may be allowed an AMT tax credit for prior year AMT.

E Employee Stock Purchase Plans

You do not include any amount in income when you are granted an option under an employee stock purchase plan or when you exercise the option. You recognize income only when you sell the stock. Get IRS Pub. 525, *Taxable and Nontaxable Income*, for more information on the taxation when you sell the stock acquired under an employee stock purchase plan.

If you paid tax to California and another state on any ordinary income recognized when you sell the stock, you may be allowed a credit for taxes paid on this double-taxed income. Get California Schedule S, *Other State Tax Credit*, for more information.

Qualifying Disposition

A qualifying disposition occurs when the holding period requirements under IRC section 423 are met.

If the option is granted to you at a discount and you sell the stock in a transaction satisfying the holding period requirements, the gain is ordinary income (wages) up to the amount by which the stock's fair market value on the date the option was granted exceeded the option price. Any excess gain is capital gain. If you have a loss from the sale, it is a capital loss, and you do not have any ordinary income.

Disqualifying Disposition

A disqualifying disposition results when you sell the stock without meeting the holding period requirements. Your ordinary income is the amount by which the stock's fair market value on the date you exercised the option exceeded the option price. You must increase your basis in the stock by the amount of this ordinary income. The difference between your increased basis and the selling price of the stock is a capital gain or loss.

Change of Residency to California (Move-in)

Qualifying or Disqualifying Disposition

If you exercise an option under an employee stock purchase plan while a nonresident and later sell the stock in a qualifying or disqualifying disposition while a California resident, the resulting ordinary income and capital gain are taxable by California because you are a California resident when the stock is sold.

Example 9 – On March 1, 1998, while a resident of Massachusetts, your employer granted you options at a discount under an employee stock purchase plan. On March 1, 2000, you exercised your options. On December 1, 2000, you permanently moved to California and on April 1, 2001, you sold the options at a gain.

Determination: The resulting ordinary income and capital gain are taxable by California because you are a resident of California when the stock is sold. If you also paid tax to Massachusetts, you are allowed a credit against California taxes for taxes paid to Massachusetts on the double-taxed ordinary income.

Change of Residency From California (Move-out)

Qualifying or Disqualifying Disposition

If you exercise an option under an employee stock purchase plan while a resident and later sell the stock in a qualifying or disqualifying disposition while a nonresident, the resulting ordinary income is taxable by California to the extent you performed services in California from the grant date to the exercise date. Any capital gain has a source in your state of residence at the time you sold the stock.

Example 10 – On February 1, 1998, your employer granted you options under an employee stock purchase plan. On February 1, 2000, you exercised these options. From the grant date to the exercise date, you were a California resident and performed 50 percent of your services in California. On June 1, 2000, you permanently moved Nevada and on January 15, 2001, you sold the stock at a gain.

Determination: Because you sold the stock before meeting the one-year holding period requirement, the difference between the fair market value of the stock on the date of exercise and the option price is taxable as wages. Since you performed 50 percent of your services in California from the grant date to the exercise date, 50 percent of the wage income would be taxable by California. Any capital gain resulting from the increase in value over the fair market value on the date of exercise would have a source in Nevada, your state of residence when you sold the stock.

F California Qualified Stock Options

California R&TC section 17502 provides that a stock option specifically designated as a California qualified stock option will receive the favorable tax treatment applicable to incentive stock options and employee stock purchase plans. In order to receive this treatment, the following conditions must be met:

1. The option is issued after January 1, 1997, and before January 1, 2002.
2. The earned income of the employee to whom the option is issued does not exceed $40,000 in the tax year in which the option is issued.
3. The number of shares of stock granted under the option does not exceed 1,000, and the value of the shares does not exceed $100,000.
4. The employee must be employed by the company at the time the option is granted or must have been employed within three months (one year if permanently disabled) of the date the option is granted.

If the provisions of R&TC section 17502 are met, federal law treats a California qualified stock option as a nonstatutory stock option. For federal tax purposes, you recognize taxable wage income upon the exercise of a California qualified stock option. You should make an adjustment to your federal adjusted gross income for the California qualified stock option wage income you included on your federal return. Make the adjustment on **one** of the following schedules:

- Schedule CA (540), *California Adjustments-Residents*
- Schedule CA (540NR), *California Adjustments-Nonresidents or Part-Year Residents*

In the year you sell the stock, you should report any capital gain or loss differences on California Schedule D, *California Capital Gain or Loss Adjustment*.

See the Incentive Stock Options section of this publication to determine the California taxation of these options if you change your residency.

If the provisions of R&TC section 17502 are not met, the stock option is treated as a nonstatutory stock option. See the Nonstatutory Stock Options section of this publication to determine the California taxation of these options if you change your residency.

California Tax Treatment of Stock Options Summary Table

Type of stock option	If you are a California resident	If you are a California nonresident
Nonstatutory stock option (NSO)	**on the date you exercise your NSO:** • Wage income is taxable by California. • Possible other state tax credit.	**on the date you exercise your NSO:** • Wage income is taxable by California to the extent you performed services in California from the grant date to the exercise date. • Possible other state tax credit.
	on the date you sell the stock: • Capital gain is taxable by California.	**on the date you sell the stock:** • Capital gain is not taxable by California.
Incentive stock option (ISO)	**on the date you exercise your ISO:** • AMT adjustment is made if you do not sell the stock in the year of exercise. • Increase your AMT basis by the AMT adjustment.	**on the date you exercise your ISO:** • AMT adjustment is made if you do not sell the stock in the year of exercise. • AMT adjustment is included to the extent you performed services in California from the grant date to the exercise date. • Increase your AMT basis by the AMT adjustment.
	on the date you sell the stock in a qualifying disposition at a gain: • Capital gain is taxable by California. • Possible AMT credit.	**on the date you sell the stock in a qualifying disposition at a gain:** • Capital gain is not taxable by California. • Possible AMT credit.
	on the date you sell the stock in a disqualifying disposition: • Wage income and capital gain (if any) are taxable by California. • Possible other state tax credit. • Possible AMT credit.	**on the date you sell the stock in a disqualifying disposition:** • Wage income is taxable by California to the extent you performed services in California from the grant date to the exercise date. • Capital gain (if any) is not taxable by California. • Possible other state tax credit. • Possible AMT credit.
Employee stock purchase plans (ESPP)	**on the date you sell the stock in a qualifying or disqualifying disposition at a gain:** • Ordinary income and capital gain are taxable by California. • Possible other state tax credit.	**on the date you sell the stock in a qualifying or disqualifying disposition at a gain:** • Ordinary income is taxable by California to the extent you performed services in California from the grant date to the exercise date. • Capital gain (if any) is not taxable by California. • Possible other state tax credit.
California qualified stock options (CQSO)	**and R&TC Section 17502 provisions are met:** • Same tax treatment as ISO.	**and R&TC Section 17502 provisions are met:** • Same tax treatment as ISO.
	and R&TC Section 17502 provisions are not met: • Same tax treatment as NSO.	**and R&TC Section 17502 provisions are not met:** • Same tax treatment as NSO.