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Connecticut Supreme Court Upholds Taxation of Stock Options Exercised by Nonresident

On December 28, the Connecticut Supreme Court confirmed that Connecticut properly could tax income recognized by a nonresident upon the exercise of stock options awarded as part of his compensation for services performed in Connecticut. Jefferson Allen vs. Commissioner, ____ Conn. ___ (December 28, 2016).

The taxpayer had received stock options during two periods when he was employed in Connecticut. Both sets of options were exercised after the taxpayer had become a nonresident. The taxpayer paid Connecticut tax upon each of the exercises and later sought refunds on the bases that the taxation of the options was contrary to Connecticut's own income tax regulations and also violated the due process clause of the federal Constitution.

The Supreme Court noted first that the taxpayer's claim for refund with respect to the initial exercise of options was untimely, as it was brought more than three years from the due date of the return for the tax year in which the options were exercised.

Next, the Court considered the taxpayer's contention that under the applicable income tax regulation, income from options was taxable only if the taxpayer was performing services in Connecticut at the time the options were granted as well as the time that the options were exercised. The Court rejected that construction, holding that the regulation required only that the taxpayer be performing services in Connecticut at the time the options were granted. The Court noted that construing the regulation as proposed by the taxpayer could lead to "bizarre results" in that a break of service somewhere between the time that the option was granted and the time the option was exercised would allow a taxpayer to avoid any taxation by Connecticut.

The Court also rejected the taxpayer's claim that the taxation by Connecticut of options exercised by a nonresident violated the due process clause. The Court concluded that the fact that the taxpayer was granted the options as compensation for performing services in Connecticut served as sufficient nexus under the due process clause for Connecticut to tax the income attributable to the exercise of the options.

Finally, the Court rejected the taxpayer's argument that the income realized from the exercise of the options was the result of the appreciation in value of the underlying stock, which was not connected to the taxpayer's performance of services within the state. The Court noted that although options do have value at the time they are awarded, that value is speculative, which is why under federal tax law there generally is no recognition of income until the time at which the option is exercised and the income is determinable.

The Court determined that "[d]ue process does not demand that compensation be taxed by application of a formula that utilizes economic values that are ascertainable only contemporaneously with the performance of services in the taxing state." Rather, it is sufficient to satisfy due process requirements that the taxpayer has performed the services in the taxing state.