

Can California Tax Options and Restricted Stock After You Move Away?

By Robert W. Wood

2025 was the sixth year in a row in which California claimed the dubious title of the state with the most residents moving away to greener pastures. People move states for lots of different reasons, but California's high cost of living and high taxes are a constant refrain if you ask people what sparked their wanderlust. Whether the destination is a no-tax state like Texas, Nevada, Wyoming or Florida, or any state with a more modest and reasonable state tax rate than California's eye-watering 13.3%, people are likely to fare better tax-wise elsewhere.

The top tax rate in the Golden State is 14.4%, although for most types of income, it is 13.3%, which is not much better. What's more, the 13.3% rate applies equally to ordinary income and capital gain. With the IRS, the capital gain rate is zero on lower incomes, and even at the highest income levels, the federal capital gain rate tops out at 20%, a nice savings off the ordinary income rate of 37%.

Even if you add the 3.8% federal net investment income tax under the Affordable Care Act, you have a maximum federal tax of 23.8% on capital gains. For many Californians, adding a whopping 13.3% state tax can be downright painful. If you are about to sell your stock, large amounts of crypto, or settle a big lawsuit, it can be tempting to move out of state before you sell. Of course, if you aren't careful when and how you move, you could end up being audited by California's tough Franchise Tax Board.

As the FTB is aware, some people have a hard time distancing themselves from California. California, like the IRS, gets unlimited time to audit if you never file a tax return, and that rule catches many people who move away. It can make filing a non-resident tax return—just reporting your California-source income as a non-resident—a smart move.

So how do moves impact stock options and similar equity-based compensation? You might assume that once you living in a new state, you are safe from California taxes, but it's not that simple. Many California employees get options or other equity based compensation from their employer. They can be worth a lot, so it is good to know some basic rules about how taxes work on options and restricted stock. How and when stock options and restricted stock are taxed can be complex even if you are only considering federal taxes.

Stock Options

Incentive Stock Options (ISOs) are taxed favorably. There is generally no tax when they are granted. There is also no regular tax when they are exercised. Thereafter, when you sell shares you acquired on exercise, you will pay tax, hopefully as a long-term capital gain. The usual long-term capital gain holding period is more than one year. However, to get long-term capital gain treatment for shares acquired via ISOs, you must: (1) hold the shares for more than a year after you exercise the options; and (2) sell the shares at least two years after your ISOs were granted.

Nonqualified Stock Options (NSOs)

The other type of option is nonqualified stock options (NSOs). Because of conditions and limits on ISOs, if you are an executive, you are more likely to receive some or all of your options as NSOs. NSOs are more prevalent than ISOs. They are not taxed as favorably as ISOs, but at least there is no AMT trap.

Plus, NSOs offer some planning possibilities that ISOs do not. As with ISOs, there is no tax when the option is granted. But when you exercise an NSO, you owe ordinary income tax (and if you are an employee, Medicare and other payroll taxes) on the difference between your price and the market value.

Example: John receives an option to buy stock at \$5 per share when the stock is trading at \$5. Two years later, he exercises when the stock is trading at \$10 per share. John pays \$5 when he exercises, but the value at that time is \$10, so he has \$5 of compensation income. Then, if John holds the stock for more than a year and sells it, any sales price above \$10 (his new basis) should be long-term capital gain.

Exercising options to buy stock takes money and generates taxes. That's why many people exercise options to buy shares and then sell those shares the same day. Some stock option plans permit a "cashless exercise" to cut down on the round-trip flow of funds. On the other hand, there's no requirement that you exercise and immediately sell the acquired shares. If you expect future appreciation in the shares, you might not want to sell. With an NSO, you can exercise and then hold the shares you acquire. You need only hold the stock for more than a year to get long-term capital gain treatment on any additional appreciation postexercise.

Restricted Stock

If you receive stock (or any other property) from your employer with conditions attached (say, you must stay for two years to get it or to keep it), special restricted property rules apply.

Example: As a carrot to stay with the company, Sam's employer says that if he remains with the company for 36 months, he will be awarded \$50,000 worth of shares. Sam does not have to pay anything for the stock. It is a bonus, but it is clearly given to him for performing services. Sam has no taxable income until he receives the stock. In effect, the IRS waits 36 months to see what will happen. When Sam receives the stock, he has income measured by the value of the stock at that time. That might be more or less than \$50,000, depending on how the shares have done in the meantime. The income is taxed as wages, so income and employment taxes apply.

With restrictions that will lapse with time, the IRS waits to see what happens before taxing that income. Yet some restrictions will never lapse, and are referred to as non-lapse restrictions. With non-lapse restrictions, the IRS values the property subject to those restrictions

Moving States

If you hold shares of stock—say stock in Amazon—and move states, you can safely sell the stock and report the gain to the IRS and your new state. The stock is an intangible

asset, and it is taxed based on your residence. If your new state has no income tax, so much the better. Perhaps because of the way stock sales are taxed, there's often confusion about options and restricted stock when people move out of California.

What if you move away from California, before you get a healthy payment? The problem is that equity-based compensation is still fundamentally *compensation for services*. Therefore, if you are a California non-resident when you recognize the income for tax purposes, the income is sourced to the location where you *provided the services* that earned the equity-based compensation.

It is possible that the equity-based compensation was granted when you were a resident of California, but that it did not fully vest or was not exercised until after you left California. California law does not dictate a required formula for allocating income from equity-based compensation between California-source and non-California source income, but only requires that the allocation be reasonable. Nevertheless, it appears that it is generally accepted and reasonable to allocate the income based on time spent in California.

For *nonqualified* stock options (NSOs), it is generally acceptable to allocate the income generated upon the exercise of the option based on the number of days working in California, versus the number of days working outside of California between the date of grant and the date of *exercise*. There are some tax authorities suggesting that it may also be reasonable to allocate the income generated by exercising the option by looking at the period between the date of grant and the date of *vesting* (instead of the date of *exercise*).

This same standard is also generally used for restricted stock units and other equity-based deferred compensation. Therefore, if you perform most of your work in California, and if you move immediately before exercising an option or immediately before RSUs vest, most of the income from the exercise or vesting of the deferred compensation may still be taxable in California.

For incentive stock options (ISOs), under federal law there is no wage portion. Instead, an incentive stock option is only taxed as capital gain when sold (assuming you hold the shares received for the required amount of time before selling them). California law conforms to the federal tax rule. Therefore, ISOs do not generally result in California tax (other than potentially for AMT purposes) when exercised. Moreover, because capital gain from the sale of shares is generally sourced to the residency of the owner, there may not be California-source income when you later sell the shares received from the exercise of the ISO.

California taxes can be particularly daunting after a move. The state doesn't like to lose revenue, and it is famous for being rigorous in its collection efforts. An audit or notice from the FTB should be taken seriously. Most tax lawyers and accountants say that IRS audits and tax disputes are easier to resolve than their California counterparts. That should tell you something.

Robert W. Wood practices law with www.WoodLLP.com, and is the author of "*Taxation of Damage Awards & Settlement Payments*" (www.TaxInstitute.com). This discussion is not intended as legal advice.