DEPARTMENT OF TAXATION
2026 Fiscal Impact Statement

1. **Patron** Bill DeSteph

2. **Bill Number** SB 211
   House of Origin:
   X **Introduced**
   ____ **Substitute**
   ____ **Engrossed**

   Second House:
   ____ **In Committee**
   ____ **Substitute**
   ____ **Enrolled**

3. **Committee** Senate Finance and Appropriations

4. **Title** Income Tax; Incentive Stock Option Subtraction

5. **Summary/Purpose:**

   This bill would provide an individual income tax subtraction for any income received as gains from exercising incentive stock options that were previously taxed in another state.

   This bill would be effective for taxable years beginning on and after January 1, 2026.

6. **Budget amendment necessary:** No.

7. **Fiscal Impact Estimates are:** Preliminary. (See Line 8.)

8. **Fiscal implications:**

   <u>Administrative Costs</u>

   The Department of Taxation ("the Department") considers this bill as routine and does not require additional funding.

   This legislation does not require significant changes to the Department's systems and is not impacted by the first phase of the Integrated Revenue Management System (IRMS) replacement project. No resource constraints or implementation considerations are anticipated.

   <u>Revenue Impact</u>

   This bill would have an unknown negative General Fund revenue impact beginning in Fiscal Year 2027 and each year thereafter.

9. **Specific agency or political subdivisions affected:**

   Department of Taxation

10. **Technical amendment necessary:** No.

11. Other comments:

<u>Background</u>

Incentive Stock Options

Incentive Stock Options ("ISOs") are a type of employee stock option that some employers, usually corporations, grant to employees as compensation. They give employees the right to buy company stock at a fixed "strike" or "exercise" price in the future. ISOs generally follow a vesting schedule, requiring employees to remain with the company for a set period before the options become exercisable.

When an employee exercises the option (i.e., purchases the shares) after the vesting period, they usually acquire the stock at a price below its current fair market value. This difference between the market value and the exercise price is called the option spread, an immediate economic gain. This option spread is an imputed gain that exists immediately at exercise because the employee acquires shares worth more than the amount paid.

Federal Tax Treatment of Incentive Stock Options

ISOs are not subject to federal income tax at the time they are granted or exercised unless the statutory requirements are not met. The gains are recognized when the shares are sold, and they are treated as capital gains provided that a two-year holding period is met. If the shares are sold before the holding period ends, the gains are treated as ordinary income. Although the exercise of an ISO is not typically taxed under regular federal income tax rules at the time of exercise, the option spread may be included for purposes of the Alternative Minimum Tax ("AMT"). As a result, the taxpayer may owe AMT even if the shares are not sold after exercise.

State Tax Treatment of Incentive Stock Options

Tax rules regarding ISOs vary by state and depend heavily on timing and residency. Some states use a source-based approach that taxes ISO income based on where the work was performed and some states use a residence-based approach that taxes ISO income based on the taxpayer's current residence. Others use a hybrid approach that considers both where the work was performed and the taxpayer's current residency.

The disparate methods that states use to tax ISO income can lead to double taxation when a taxpayer moves from a state that uses a source-based approach to one that uses a residence-based approach. Some states provide tax credits to help address the possibility of double taxation.

Virginia Tax Treatment of Incentive Stock Options

Virginia treats the appreciation in the value of stock from the date of grant to the date of exercise is compensation from Virginia sources for services performed in Virginia by an employee who is granted ISOs. If a taxpayer moves from Virginia after the date the ISOs were granted, the nonresident taxpayer is subject to Virginia income tax on the appreciation of the value of the stock. Further, the amount of a nonresident's Virginia source income with respect to ISOs granted in connection with Virginia employment is determined at the time the stock is sold and income or gain is recognized for federal purposes.

The compensation earned from the appreciation of stock acquired through ISOs will not be considered Virginia source income for nonresidents provided that the individuals were not residents of Virginia for at least two years prior to the sale of the stock. Nonresident taxpayers who do not meet the two-year holding requirement are subject to Virginia income tax on the appreciation of stock granted pursuant to ISOs. Their Virginia source income is an amount equal to (1) the lesser of the income or gain recognized for federal income tax purposes or the amount by which the fair market value of the stock exceeded the option price at the date the ISO was exercised, (2) multiplied by the number of days of the taxable year(s), or portions) thereof, that the individual resided in Virginia from the period of the ISO grant date to the date of exercise, and (3) divided by the number of days from the ISO grant date to the date of exercise.

For Virginia income tax purposes, capital gains are taxed at the same rate as all other income.

<u>Virginia’s Individual Income Tax Modifications</u>

Federal Adjusted Gross Income

Virginia’s Individual Income Tax substantially conforms to federal income tax law by using federal adjusted gross income (“FAGI”) as the starting point for computing Virginia income taxes. Virginia law then provides various modifications to FAGI that must be taken into account that figure in determining Virginia taxable income.

Virginia Adjusted Gross Income

When completing a Virginia individual income tax return, a taxpayer starts with the amount of FAGI reported on his federal return. A taxpayer then calculates Virginia adjusted gross income by making two types of adjustments: (1) “additions” which increase the amount of income taxable by Virginia and (2) “subtractions” which reduce such amount. These adjustments are made only to the extent that they have not already been included or excluded from FAGI.

Virginia Taxable Income

The taxpayer calculates his Virginia taxable income by making another type of modification referred to as “deductions,” which further reduce the amount of income taxable by Virginia. These modifications are made regardless of federal treatment unless specifically stated otherwise in the provision.

Please find below an illustration of how taxable income is computed for federal and Virginia income tax purposes and how they interrelate:

Federal Income Tax	Virginia Income Tax
+Wages and Other Income	*=Federal Adjusted Gross Income ("FAGI")*
+Federal Adjustments	+Virginia Additions (only if not included in FAGI)
-Federal Adjustments	-Virginia Subtractions (only if not excluded from FAGI)
=Federal Adjusted Gross Income ("FAGI")	*=Virginia Adjusted Gross Income ("VAGI")*
-Federal Standard Deduction or Itemized Deductions	-Virginia Standard Deduction or Federal Itemized Deductions (depends on federal election)
-QBI Deduction	-Deduction for Virginia Exemptions
	-Virginia Deductions (regardless of federal treatment)
=Federal Taxable Income	*=Virginia Taxable Income*

Because this bill would establish a new Virginia income tax subtraction, the amount allowed under this bill could be taken whether the taxpayer chooses to take the Virginia standard deduction or itemize their deductions.

<u>Proposed Legislation</u>

This bill would provide an income tax subtraction for any income received as gains from exercising incentive stock options that were previously taxed in another state.

"Incentive stock option" means an option contract, granted by the employer corporation or its parent or subsidiary corporation, to an individual for any reason connected with his employment by a corporation, to purchase stock of any of such corporations, but only if:

(i) The option is granted pursuant to a plan that (a) includes the aggregate number of shares that may be issued under options and the employees, or class of employees, eligible to receive options, and (b) is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;
(ii) Such option is granted within 10 years from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever is earlier;
(iii) Such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted;
(iv) The option price per share is not less than the fair market value of the stock at the time such option is granted;
(v) Such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution and is exercisable, during his lifetime, only by him; and
(vi) Such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all

classes of stock of the employer corporation or of its parent or subsidiary corporation.

"Incentive stock option" does not include any option if, as of the time the option is granted, the terms of such option provide that it will not be treated as an incentive stock option.

This bill would be effective for taxable years beginning on and after January 1, 2026.

cc : Secretary of Finance

Date: 01/17/2026 JLOF
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