Option and Restricted Stock Basics: Part I

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M&A advisors—lawyers, accountants, bankers and consultants—all have some basic familiarity with stock options. They are present in virtually every deal. In fact, not infrequently, someone is discussing them without being aware whether they are incentive or nonqualified options. Tax advisors facing a pending deal had better be sure to ask up front what kind of options are in the mix, since the two are taxed differently.

There is a surprising amount of confusion over these issues. Bankers, accountants, deal lawyers and the affected executives themselves not infrequently have to go to the tax lawyers for even the most pedestrian option questions. Tax lawyers shouldn't be the only ones to appreciate option plans and their tax impact (both immediately and down the road). Here are the basics.

Different Options

There are two types of stock options: incentive stock options (usually referred to by their catchy ISO moniker) and nonqualified stock options (or NSOs). Some employees receive both. Sometimes nonemployees (meaning consultants or independent contractors) receive options.

The plan under which options are awarded should expressly state which type you are receiving. Individual option grants should also make this clear. In the absence of those items, though, don't rely on someone's say-so whether you are dealing with one or the other.

Most people would say that ISOs are taxed more favorably than NSOs. There is generally no tax at the time ISOs are granted and no "regular" tax at the time ISOs are exercised. We'll come back to the "regular" versus not-so-regular tax shortly.

When you exercise an ISO, you acquire the shares. Thereafter, when you sell your shares, you will pay tax, hopefully as a long-term capital gain. However, you need to know a special rule about selling shares you acquired *via* exercising an ISO or you'll get tripped up.

The usual capital gain holding period is one year. Nevertheless, to get capital gain treatment for shares acquired *via* ISOs, you must:

- hold the shares for more than a year, and
- sell the shares at least two years after your ISOs were granted. This latter two-year rule catches many people unaware.

Unkind AMT

Although you pay no regular tax when an ISO is exercised, the alternative minimum tax (AMT) is not considered a regular tax. As the following example demonstrates, the AMT can take its own tax bite when you exercise ISOs. Like the two-year disposition rule noted above, the AMT catches many taxpayers unaware. It's not something you want to discover for the first time as you're preparing your tax return.

Example. Alice receives ISOs to buy 100 shares at the current market price of $10 per share. Two years later, when shares are worth $20, Alice exercises, paying $10. The $10 spread is subject to AMT. How much AMT Alice pays will depend on her other income and deductions, but it could be a flat 28-percent AMT rate on the $10 (28% × $10 = $2.80).

Note that one does not generate cash when exercising ISOs. That means if the exercise triggers an AMT tax, you will have to use other funds to pay the AMT.

NSOs: The Other Option

Because of conditions and limits on ISOs, if you are an executive, you are more likely to receive all or most of your options as nonqualified options (NSOs). In fact, NSOs are far more prevalent than ISOs. They are not taxed as favorably as ISOs, but at least there is no AMT trap. Moreover, NSOs offer some planning possibilities that ISOs do not.

With NSOs, there is no tax at the time the option is granted. When you exercise the option, however, you have ordinary income (and, if you are an employee, employment taxes). An ISO, in contrast, produces no regular tax, but does trigger the AMT. With an NSO, the *exercise* triggers income. When you exercise the NSO, you are taxed on the difference between what you pay and the value of the stock you buy.

Example. John receives an option to buy stock at $5 per share when the stock is trading at $5. Two years later, John exercises when the stock is trading at $10 per share. John pays $5 when John 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 (John's new basis) should be long-term capital gain.

Exercising options takes money, and generates tax to boot. That's why many people exercise NSOs to buy shares but then sell those shares the same day. Some plans permit a cashless exercise, cutting down on the seemingly meaningless round trip flow of funds.

On the other hand, there's no requirement that you exercise and immediately sell the acquired shares. With an NSO, you might exercise and then hold the shares you acquire. As the example above makes clear, you only must hold the stock for more than a year to get long-term capital gain treatment on any appreciation.

Restricted Stock Basics

If you receive stock (or any other property) from your employer with conditions attached (*e.g.*, you must stay for two years to get it or to keep it), Code Sec. 83 will govern. These rules are confusing, in part because they are often paired with the rules governing stock options. First, let's consider pure restricted property.

If a worker receives stock or other property subject to restrictions and those restrictions will lapse with time, the IRS waits to see what happens before taxing it.

Example. As a carrot to stay with the company, Sam's employer agrees that if he remains with the company for 36 months, he will be awarded $50,000 worth of stock. Sam does not have to pay anything for the stock. He'll simply receive it as a bonus. Sam has no tax consequence until he receives the stock. In effect, the IRS waits 36 months to see what will happen. When Sam receives the stock, he will have income (measured by the value of the stock at that time), which will be treated as wages.

Some restrictions will never lapse and are referred to as "nonlapse" restrictions. Taking a wait-and-see approach won't work with nonlapse restrictions, so the IRS values the property taking those restrictions into account.

Example. Betty's employer promises her stock if she remains with the company for 18 months. When she receives the stock it will be subject to permanent restrictions under a company buy/sell agreement to resell the shares for $20 per share if Betty ever leaves the company's employ. The IRS will wait and see (no tax) for the first 18 months. At that point, Betty will be taxed on any value she receives in excess of the price she pays. Here, Betty is not separately paying anything for the shares, and there is a $20 resale price. That means she will probably be treated as receiving $20 of compensation.

What's good for goose is also good for the gander. In most cases, the employer is allowed a deduction under Code Sec. 162 for the compensation paid once the restriction lapses. The amount of this deduction includes the appreciated value of the company's stock while the restriction on such property was in place.

Conclusion

The most enticing aspect of Code Sec. 83 is the election allowed to transferees of stock and other property to lock in (and restrict) the ordinary income element of the compensation in the year of receipt. The corollary and even better consequence of the election is to enjoy capital treatment for any subsequent appreciation. This is so even though the worker's property is subject to a risk of forfeiture.

Nevertheless, this topic, and its numerous moving parts, will have to wait for our next issue and Part II of this article.

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