Accounting and Tax Basics of Nonqualified Options

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Tax and accounting treatment may sound like synonyms to most people. In reality, of course, they are often quite different. There is a whole body of topics under the rubric of book-tax differences. They are relevant precisely because these areas can be so divergent.

An example is stock options, whether they be nonqualified stock options (NSOs) or incentive stock options (ISOs). Whether one believes the tax benefits of ISOs are as great as they are cracked up to be, it is indisputable that there are a number of qualification restrictions on ISOs that make them unattractive to many circumstances. ISOs, for example, are subject to many approval requirements, timing and duration requirements, exercise rules, percentage tests and a whole host of other limitations.

For these and other reasons, NSOs constitute the bulk of the options issued in America today. When option holders ask tax professionals about the tax impact of their options, it is surprising that some holders do not appreciate that there are differences and do not say which they have. More than a few taxpayers have to dig for their copy of the plan documents, unsure what kind of options they hold. It is even more surprising that some tax advisors do not ask to see the option plans for themselves.

Nonqualified Options Accounting

NSOs are best defined by exclusion. They encompass all options that do not meet the special requirements for ISOs. NSOs may be granted to employees and nonemployees alike in exchange for their services. That means awarding NSOs to either employees or to independent contractors or consultants is acceptable. There are no restrictions on the options, making them infinitely flexible.

The tax rules governing NSOs are pretty straightforward. NSOs granted in connection with the performance of services are not taxable when granted unless they carry a readily-ascertainable fair market value. NSOs with a readily ascertainable fair market value are generally only those traded on an established securities market.

When an NSO is exercised and stock is received, the holder is taxed on the difference between the price paid for the stock (the option exercise price) and the market value. This treatment applies whether or not the option holder retains the stock after the exercise or immediately sells it. [*See* Reg. §1.83-7(a). *See also* Rev. Rul. 78-175, 1978-1 CB 304.] The income from the exercise of the options is not only income, but constitutes compensation for services. [*See* Reg. §1.83-7(a).]

Thus, employment taxes (and withholding rules) apply. This can and does make the exercise in an employee setting somewhat awkward. A good deal of NSO planning involves trying to avoid this ordinary income/compensation rule.

An exception specifies that income will not be recognized on the date the NSO is exercised if the stock received is subject both to a substantial risk of forfeiture, and is nontransferable. In this event, the recipient of the stock will not be taxed until either of these two conditions lapse. [Code Sec. 83(a).] Once again, a good deal of energy is expended in looking at these transferability and risk of forfeiture conditions.

Code Sec. 83(b) Election

An exception to this rule for NSOs applies where the employee elects to include the value of the option in income at the date of grant, even though it is subject to a substantial risk of forfeiture. This is the fabled Code Sec. 83(b) election. The employee makes a Code Sec. 83(b) election, a one-page form that essentially says "I want to be taxed now."

Predictably, these forms are typically filed only where the value of the option (valued without regard to the restrictions on the

option) is low. In fact, in many cases, the Code Sec. 83(b) election is filed reporting a value of zero. It has long been true that a traditional goal of a Code Sec. 83(b) election is aggressive. One wants to take as little as possible into (ordinary) income.

Nevertheless, because of the Code Sec. 83(b) election, the balance (that will eventually be realized when the option is exercised and the stock is later sold) should all be taxed as a capital gain. Assuming that the stock is held for the requisite holding period, it will be long-term capital gain. Yet timing, as well as tax rates, can be impacted.

Indeed, by virtue of making a Code Sec. 83(b) election, the timing of the tax obligations will differ. The income recognition event upon making the Code Sec. 83(b) election may be a very small one, even zero. Because something is taken into income currently, the tax return due date would generally be April 15 of the year following the election.

But even if that election reports little or no income, timing is altered. If the election is made, the exercise of the options will not be a taxable event. Instead, the exercise will simply be a purchase.

Instead of having the spread between the option exercise price and the value of the stock constituting income, the exercise of the opinion in the wake of a Code Sec. 83(b) election is thereafter anticlimactic. The action triggers a stock purchase. Yet it is a purchase only and not a taxable event *viz.* the person acquiring the shares.

Election Warnings

Code Sec. 83(b) elections are simple, and even deciding whether to file such an election is not complex. There is a little bit of crystal ball gazing, but that is hardly nuanced. However, these facts somehow do not seem to prevent some significant gaffes in this area.

For example, there is the old market value problem. If you pay market value for something, how could there be a compensatory element to it? One answer is because the courts have said so. It can still be compensatory even if the option holder is paying fair market value.

Indeed, the mere fact that an NSO has a zero value does not mean that a Code Sec. 83(b) election is not required if you want to convert the potential gain into capital gain. The IRS has long successfully argued (and the Ninth Circuit has agreed) that a Code Sec. 83(b) election reporting zero value must be filed in order to convert a zero value option into a capital gain asset when the option is later exercised. [*See L.J. Alves*, 79 TC 864, Dec. 39,501 (1982), *aff'd* CA-9, 84-2 USTC ¶9546, 734 F2d 478 (1984).]

Another point about Code Sec. 83(b) elections relates to simple mechanics and deadlines. Sadly, many mistakes are made in such pedestrian compliance details, even by tax professionals one would think should know better. A Code Sec. 83(b) election must be made within 30 days of the grant of the restricted property (in this case, the options). Also, the election must be filed within this 30-day period.

Then, a copy of the election must be filed with the taxpayer's return for the year in which the options were granted. These details are simple and I have never heard of a tax practitioner claiming that Code Sec. 83(b) elections are the subject of serious scrutiny. In fact, given the low level of IRS interest that seems generally to prevail, I have wondered whether the original black hole is simply the place where the IRS puts Code Sec. 83(b) elections to die.

NSOs for Financial Statement Purposes

Most tax lawyers and many corporate executives are aware that there are earnings charge implications of stock options. ISOs also suffer materially from this earnings charge issue. Yet despite the reach of these rules, many have not thought seriously about the accounting treatment impacting options in any detail.

Although the financial statement treatment of NSOs is pretty straightforward, it is also different from the tax treatment NSOs receive. Fortunately, a company is not required to take a charge against earnings at the time NSOs are granted. It is only when they are exercised (and compensation is actually payable) that a charge to earnings is required.

A Code Sec. 83(b) election, by definition, involves the employee/optionholder making an election to include something in income currently. Thus, at that point, the same financial statement charge would apply to the company.

Of course, it would only apply to the extent that the employee/optionholder took something into income. As noted above, the Code Sec. 83(b) election is often filed reporting zero or very little income. In such cases, this is not much of a concern to the financial statement of the company.

Tax Deduction on NSOs

Issuers of NSOs are often in the position of wanting to hire, retain and incentivize employees and independent contractors. Yet such issuers hope not to need large amounts of cash to do so. NSOs are ideal for this purpose.

From a tax perspective, the issuance—which does not involve paying anything from a cash perspective—does not indicate that much is taking place. For federal income tax purposes, when an NSO is issued, the company has not yet "paid" anything. In fact, this condition continues until the time consideration becomes taxable to the employee.

There is a predictable reciprocity here. Assuming that the NSO is subject to restrictions (as most are), there is no income to the employee until the time that those restrictions lapse. As a corollary, there is also no tax education to the company until the time that these restrictions lapse.

However, the situation on exercise is decidedly different. If an NSO is exercised and the option has a spread between exercise price and fair market value, the amount of that spread has a material tax impact. It gives rise to income to the worker/recipient and a deduction to the issuing corporation.

It is not just an income tax consequence but an employment tax consequence as well. The spread must be taken into income as wages by the employee/optionholder. Of course, this generates a corresponding deduction for the spread to the company.

Conclusion

Stock options are invaluable tools. They can bring big rewards for workers (including independent contractors) as well as for the issuing company and its shareholders. Although our stock markets may currently be languishing, that will not always be so. The tax and accounting basics of NSOs are simple. There is rarely a good excuse for failing to fully comply with the rules.

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