

Tax Refresher on Options and Restricted Stock

by Robert W. Wood



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This discussion is not intended as legal advice.

In this article, Wood explains the basics of equity-based compensation. There are multiple different stock options, with tax and economic advantages that follow, but there can be tax traps, too. Wood examines how to avoid those traps.

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If you work for a salary and a cash bonus, you may not know much about stock options or restricted stock. But these days, it pays to know the basics. In the corporate world, equity and equity-based compensation are major parts of the playing field. And with start-ups, this can be a key reason to join. In many jobs, the biggest paydays are from equity, not from cash.

You might be offered stock or options in lieu of, or in addition to, your regular pay. Even outside lawyers and other consultants can sometimes get a piece of the action. Sometimes non-employees (meaning independent contractors) receive options or restricted stock, too.

If a company offers you restricted stock or stock options, there can be tax and economic

advantages, but there can be tax traps, too. And you might not know that you walked into a trap until years later.

Incentive Stock Options

Let's start with options. There are two types — incentive stock options (ISOs) and nonqualified stock options (NSOs) — and the tax rules are quite different for each. Some employees receive both. Your plan (and your option grant) should say which type. Individual option grants should also make this clear.

ISOs are taxed the most 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.

But be careful. 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. The two-year rule catches many people by surprise.

Beware of AMT

Again, when you exercise an ISO, you pay no regular tax. That should tip you off that there is an "irregular" tax known as the alternative minimum tax. As taxes go, it is one of the most hated.

Many people are shocked to find that even though their exercise of an ISO triggers no regular tax, it can trigger the AMT. Note that you don't generate cash when you exercise ISOs. If you owe AMT, that means you must use other funds to pay it or you arrange to sell enough stock when you exercise your options to be able to pay the AMT.

Example: Alice receives ISOs to buy 100 shares of her employer at the current market price of \$10 per share. Two years later, when shares are worth \$20, she exercises, paying \$10. The \$10 spread between her exercise price and the \$20 value is subject to the AMT. How much AMT Alice pays will depend on her other income and deductions. It could be a flat 28 percent AMT rate on the \$10 spread or \$2.80 per share.

With the AMT, run the numbers and get some advice. If the stock crashes before you sell, you could be stuck paying a tax bill on phantom income. That's what happened to many employees hit by the dot-com bust of 2000 and 2001.

Nonqualified Options

The other type of option is NSOs. Because of conditions and limits on ISOs, if you are an executive, you are more likely to receive all (or at least most) of your options as NSOs. Generally, 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.

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 very same day. Some stock option plans even 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. In fact, 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 post-exercise.

Stock Bonuses and Restricted Stock

What if the deal you're offered doesn't say anything about options? You might be given or "bonused" stock, or you might be offered the chance to buy stock. In either case, there probably will be restrictions attached regarding your employment.

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 under section 83. These rules cause significant confusion. First, let's consider pure restricted property.

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 from a tax viewpoint, 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 then. 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, which means income and employment taxes apply.

The IRS Won't Wait Forever

With restrictions that will lapse with time, the IRS always 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.

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. The stock might have a market value that is much higher. But under the buy/sell agreement, Betty would have to resell the shares for \$20 per share if she ever leaves the company's employment. The IRS will wait and see if Betty stays for the first 18 months (so no tax to Betty until then). After 18 months, Betty will be taxed on any value she receives greater than 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 taxed on \$20 of compensation.

Electing to Be Taxed Sooner?

Most tax planning involves pushing taxable events into the future. You generally want to postpone income tax recognition events. Conversely, you generally want to accelerate tax deductions. Therefore, it may sound counterintuitive to elect to include something on your tax return before it is required.

As we've seen, the restricted property rules generally adopt a wait-and-see approach for restrictions that will eventually lapse. But in some cases, you can elect to include the value of restricted property in your income earlier — in effect disregarding the restrictions. Why might this be a desirable strategy?

You may want to include the restricted property in income at a low value, locking in future capital gain treatment. Under what's known as a section 83(b) election, you can choose to include the value of the property in your income earlier, even though there are restrictions. To elect current taxation, you must file a written 83(b) election with the IRS within 30 days of receiving the property.

You must report on the election the value of what you received as compensation (which might be small or even zero). Then you must attach another copy of the 83(b) election to your tax return for that year.

Example: Sallie is offered stock by her employer at \$5 per share when the shares are worth \$5. However, she must remain with the company for two years to be able to sell them. Sallie buys the shares, paying \$5 per share. Sallie has already paid fair market value for the shares, so there's no compensatory element here. That means in filing a section 83(b) election, she could report zero income.

Yet by filing it, Sallie converts what would otherwise be ordinary income into capital gain. When she eventually sells the shares, she will have ensured her gain is long-term capital gain as long as she holds the shares for more than a year. In contrast, if Sallie fails to file a section 83(b) election, the stock will be viewed as issued for the performance of services, thus retaining an ordinary income taint.

"Wait. I paid FMV for this stock! How could it be compensation?" Sallie might say. The case law (which the IRS likes) says that even if you pay FMV, if you would not have been offered the stock but for your employment, it is compensatory. There is no harm when you receive the stock, since the FMV and the price you pay are the same.

But years later, if Sallie sells, there could be a big spread. If she failed to file an 83(b) election when she bought the stock (for which she can report zero income!), the IRS can say all Sallie's gain is ordinary, not capital.¹

Note that there is another effect of the section 83(b) election. The most obvious impact is in locking in future capital gain treatment. But the election also alters when future tax events will occur.

Example: Niles is offered stock in his employer at \$2 per share. However, he must resell the shares back to the company if he leaves its employ within the next seven years. There is no market for the stock, but \$2 represents the price the company believes the shares are worth. Niles buys his stock for \$2 and makes a section 83(b) election reporting zero income. He holds the shares, and seven

¹ See *L.J. Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984).

years later, the shares are worth \$60 per share. Then, three years after that (so 10 years after he bought his stock), he leaves the company and sells his shares for \$75 per share. Niles has a \$73 gain on each share, all taxed as long-term capital gain.

What happens if Niles does not make a section 83(b) election when he buys the stock? Here, Niles buys his stock for \$2 as before, but files no election. As a result, when the resale restrictions on his shares lapse at the end of year 7, Niles has compensation income measured by the difference between the price he paid (\$2 per share) and the FMV of the stock when the restrictions lapse, \$60 per share. That means Niles has \$58 of wage income at the end of year 7, even though he hasn't sold his shares and even though he may not have sufficient cash on hand to pay that tax. When Niles sells the shares three years after that, he has a long-term capital gain of \$15 per share.

Restricted Options?

As if the restricted property rules and stock options rules were not complicated enough by themselves, sometimes you must consider both sets of rules together. For example, you may be awarded stock options (either ISOs or NSOs) that are restricted, your rights to which vest over time if you stay with the company. The IRS generally waits to see what happens in such a case.

For example, say that you must wait two years for your options to vest. In that case, there's no tax until that vesting date. Then the stock option rules, which hinge on exercise, take over. At that point, you would pay tax under either the ISO or NSO rules.

It is even possible to make 83(b) elections for some compensatory stock options. The idea of any 83(b) election is to trigger a taxable event on the election — even if you are reporting zero income — and to start the clock running on future appreciation, which should be taxed as a long-term capital gain.

However, not all options qualify for an 83(b) election. In fact, Treasury regulations require the options to have a "readily ascertainable fair market value" to qualify for an 83(b) election. A valuation alone is insufficient. There are only two ways an option can have a readily ascertainable

FMV: (1) the option itself (not the underlying stock or other property) must be actively traded on an established market; or (2) the value of the option must be measurable "with reasonable accuracy."

Unless an option is actively traded on an established market, Treasury regulations list four features an option must contain to have a readily ascertainable FMV. If any one of them is absent, there is an irrebuttable presumption that the option does not have a readily ascertainable fair market value:

1. the option must be transferable by the optionee;
2. the option must be exercisable immediately in full by the optionee;
3. the option or the property subject to the option must not be subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) that has a significant effect on the FMV of the option; and
4. the FMV of the option must be readily ascertainable.

If your option fails any one of these tests, the irrebuttable presumption means you are stuck with ordinary income treatment when you exercise the option.

Tax Advice

Many companies that offer stock options or other incentives try to look out for your interests. After all, stock options and similar incentive plans are adopted to engender loyalty, as well as provide incentives. Some companies provide support and explanations and even help you through your questions.

However, you may still want to hire a professional to help you deal with these issues. The tax rules are complicated, especially if you have a mix of ISOs, NSOs, restricted stock, and more. Companies sometimes provide personalized tax and financial planning advice to top executives as a perk, but rarely do they provide this for everyone.

A good place to start is by reading the documents the company provides. Plus, if you seek outside guidance, you'll want to provide copies of all your paperwork to your adviser. That paperwork should include the company's plan

documents, any agreements you've signed that refer in any way to the options or restricted stock, and any grants or awards. If you actually got stock certificates, provide copies of those, too.

Beware of Section 409A

Finally, beware of section 409A of the tax code. It provides that some compensation you defer under regular tax rules is currently taxed. Stock options are generally treated as nonqualified deferred compensation under section 409A if they have an exercise price that is less than the FMV of the underlying stock on the date of the grant.

A shorthand way of referring to them is options that are "in the money" when they are granted. Get some advice if you face this situation. Companies can avoid this issue by pricing options at the FMV of the stock when the options are issued. Also, if you have an acceleration, cashing out, or modification of options, there can be extra tax risks. That might occur on a merger or on severance.

Bottom line: Enjoy your options, but be careful! ■

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