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What Everyone Should Know About Stock Options and Restricted Stock

Employee stock options are a great perk, but they can be complicated.

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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. The situation is not necessarily limited to employees. Even outside lawyers, other consultants and independent contractors can sometimes get a piece of the action. 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, and the tax rules are quite different between them. There are incentive stock options (also called ISOs), and non-qualified stock options (also called NSOs). Some employees receive both. Your plan (and your option grant) should expressly state which type. Individual option grants should also make this clear.

ISOs are taxed the most favorably. There is generally no tax at the time they are granted. There is also no "regular" tax at the time 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: (a) hold the shares for more than a year after you exercise the options; and (b) sell the shares at least two years after your ISOs were granted. The latter, two-year rule catches many people by surprise. See 26 U.S.C. § 422(a)(1).

BEWARE OF AMT

As noted above, 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, usually abbreviated to AMT. 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 the AMT, that means you will have to use *other* funds to pay it. (As an alternative, you might arrange to sell enough stock at the time 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 a share. The $10 spread between her exercise price and the $20 market value is subject to 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 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

Now let's look at nonqualified options, or 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 non-qualified options. 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 regular tax at the time the option is granted. But when you exercise a nonqualified option, 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 the act of exercising also 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 only must hold the stock for more than a year to get long term capital gain treatment on any additional appreciation post-exercise. I26 U.S.C. §1222(3).

STOCK BONUSES AND RESTRICTED STOCK

What if the deal you are offered doesn't say anything about options? You might be given or "bonused" stock. In some cases, you might be offered the chance to *buy* stock. In either case, there are probably going to be restrictions attached related to 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 of the Internal Revenue Code. See 26 U.S.C. §83. These rules cause considerable confusion. First, let's consider pure restricted property.

Example: As a carrot to stay with the company, Sam's employer says 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 in connection with 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.

IRS WON'T WAIT FOREVER

With restrictions that will lapse with time, the IRS always waits to see what happens before taxing 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, and in that sense takes the restrictions into account.

Example: Betty's employer promises her a stock bonus 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 Betty ever leaves the company's employment. The IRS will wait and see if Betty stays for the first 18 months (so there's no tax to Betty up to then). 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 taxed on $20 of compensation when she receives the shares.

ELECTING TO BE TAXED SOONER?

Most tax planning involves pushing off 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 counter-intuitive 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 are allowed to *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 an 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 filing a Section 83(b) election 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 insured 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 in connection with the performance of services, thus retaining an ordinary income taint.

Wait, Sallie might say, I paid fair market value for this stock! How could it be compensation? The case law (which the IRS likes) says that even if you pay fair market value, 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 fair market value 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 (which can report zero income!), the IRS can say *all* of Sallie's gain is ordinary not capital. For proof, see *L.J. Alves*, CA-9, 734 F2d 478 (1984).

TIMING THE TAX

Note that there is another effect of the Section 83(b) election. The most obvious impact of the election is in locking in future capital gain treatment. But the election also has the effect of altering the *time* at which 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 7 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 7 years later, the shares are worth $60 per share. Then, 3 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 *then* fair market value 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 *each* not complicated enough, sometimes you must consider both sets of rules. For example, you may be awarded stock options (either ISOs or NSOs) that are restricted, where your rights to them "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 take over, which hinge on exercise. 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 (remember the zero income 83(b) election discussed above). The idea is 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. See Reg. Section 1.83-7(a). A valuation alone is not sufficient. There are only two ways an option can have a readily ascertainable fair market value: (a) the *option* itself (not the underlying stock or other property) must be actively traded on an established market; or (b) the value of the options must be able to be measured "with reasonable accuracy." See Reg. Section 1.83-7(b).

Unless an option is actively traded on an established market, the Treasury Regulations list four features an option must contain to have a readily ascertainable fair market value. If any one of them is absent, there is an *irrebuttable presumption* that the options do *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) which has a significant effect upon the fair market value of the option; and
4. The fair market value of the option must be readily ascertainable.

Reg. Section 1.83-7(b)(2).

If you fail 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 will 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 the documents the company provides. You should read them. Plus, if you seek outside guidance, you'll want to provide copies of all your paperwork to your advisor. 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 SECTION 409A

Finally, beware of Section, 409A of the tax code. See 26 U.S.C. §409A. 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 the stock options have an exercise price that is less than the fair market value 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 fair market value 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!

Robert W. Wood is a tax lawyer with Wood LLP, and the author of numerous tax books including Taxation of Damage Awards & Settlement Payments.

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