



# Stock Options & Restricted Stock

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## I. Introduction

Corporate equity compensation awards are typically structured as either grants of stock options or issuances of restricted stock. In general, the goal of the award recipient is to defer his or her out-of-pocket purchase price and tax costs related to the award for as long as possible and to maximize the portion of his or her income from the award that is taxable at long-term capital gain rates.<sup>1</sup> Stock options can be attractive to the recipient because, within specified parameters, they allow the recipient to decide in the future whether and when to pay the purchase price for the award. Often, however, the recipient of a stock option reports most or all of his or her income at ordinary income rates, or at least has to pay tax upon exercising the option, even if the option is issued as a supposedly tax-favored “incentive stock option” (or “ISO”). The infirmities in the option rules sometimes cause the parties to equity compensation transactions to consider the use of restricted stock as an alternative.

This outline reviews and compares the tax aspects of compensatory stock option grants and restricted stock awards by a corporation.

## II. Options

Generally speaking, there are two types of compensatory options. One type of compensatory option is the ISO.<sup>2</sup> The other is the option that is not an ISO (often referred to as a “non-qualified stock option” or “NQO”).<sup>3</sup> Because ISOs are best understood in comparison to NQOs, this outline will consider NQOs first.

### *NQOs*

**Treatment of Grantee.** The grantee of a NQO generally reports ordinary compensation income upon exercising the NQO in an amount equal to the excess of (i) the fair market value, as of the time of exercise, of the stock received upon exercising the NQO over (ii) the exercise price of the NQO (the excess is sometimes referred to as the “spread”).<sup>4</sup> The grantee then

receives the underlying stock with a fair market value basis and a holding period beginning on the date of exercise.<sup>5</sup> Thus, the grantee of a NQO generally reports the pre-exercise appreciation in the value of the underlying stock as ordinary income upon the exercise of the NQO and the post-exercise appreciation in the value of the underlying stock as capital gain (long-term if he or she holds the stock for more than a year after exercising) upon the disposition of the stock.

**Treatment of Corporation.** Subject to any applicable deductibility limitations, the corporation granting the NQO has a compensation deduction that mirrors the compensation income of the grantee in both amount and timing. The corporation may be required to properly report the grantee’s compensation income on a Form W-2 or 1099, as the case may be, as a condition to taking the deduction. The corporation must also withhold and pay employment tax with respect to the grantee’s compensation income if the grantee is an employee.

<sup>1</sup> At least through 2010, the maximum federal rates applicable to ordinary income (other than dividends from domestic corporations) and most long-term capital gains (and dividends from domestic corporations) of individuals are 35% and 15%, respectively.

<sup>2</sup> The ISO rules are set forth in Sections 421 through 424 of the Internal Revenue Code (the “Code”) and the Income Tax Regulations (the “Regulations”) thereunder.

<sup>3</sup> The NQO rules are set forth in Section 83 of the Code and the Regulations thereunder. The NQOs discussed in this outline are presumed not to have readily ascertainable fair market values, within the meaning of the Regulations under Section 83 of the Code, when granted.

<sup>4</sup> Section 409A of the Code subjects the grantee of certain NQOs to tax and a 20% penalty as the option vests. The NQOs discussed in this outline are presumed to be granted with respect to “service recipient stock” and without any “additional feature of deferral” (both terms as defined in Section 409A) and at exercise prices at least equal to the fair market values of the shares underlying them on their grant dates (and are therefore presumed to be exempt from Section 409A).

<sup>5</sup> If the stock received upon exercising the NQO is “substantially nonvested” (see discussion of restricted stock below), however, the grantee is deemed to exercise the NQO when or as the stock ceases to be substantially nonvested unless he or she makes a Section 83(b) election with respect to the stock (in which case the restriction is disregarded and the exercise of the NQO is the relevant tax event).

## ISOs

### 1. Qualification Requirements.

An option may qualify as an ISO only if:

- it is granted pursuant to a written (or electronic) plan that (i) specifies (A) the maximum aggregate number of shares that may be issued under the plan through ISOs and (B) the employees (or class or classes of employees) eligible to receive grants, and (ii) is approved by the stockholders of the granting corporation within twelve months before or after the date on which the plan is adopted;
- it is granted within ten years after the earlier of the date of the adoption of the plan or the date of the approval of the plan by the granting corporation's stockholders;
- it is not exercisable more than ten (or, if the grantee is a 10% stockholder, five) years after its grant date;
- the exercise price of the option is not less than the fair market value (or, if the grantee is a 10% stockholder, 110% of the fair market value) of the underlying stock as of the grant date;
- the option is not transferable by the grantee other than by will or the laws of descent and distribution and is exercisable during the grantee's lifetime only by the grantee; and
- the grantee is an employee of either the granting corporation, a parent or subsidiary corporation of such

corporation, or a corporation (or parent or subsidiary of such corporation) substituting or assuming the stock option as a result of a corporate reorganization, from the date of the grant of the option until the date three months (or one year in the case of the grantee's death or disability) before the exercise of the option.

In addition, an option will not qualify as an ISO to the extent that the underlying stock with respect to which the option is exercisable for the first time during any calendar year has a value exceeding \$100,000 as of the grant date. For example, if an employee is granted an option to acquire stock worth \$500,000 on the grant date and the option is immediately exercisable, only 20% of the option (\$100,000/\$500,000) may qualify as an ISO. If the option vests 20% per year over five years, the option may qualify as an ISO in its entirety.

The exercisability of an ISO may be made subject to conditions that are "not inconsistent" with the rules described immediately above. Accordingly, ISOs (like NQOs) may be granted subject to vesting provisions. Typically, options vest over time. It is also possible, however, for ISOs to vest as performance goals are met.<sup>6</sup>

### 2. Treatment of Grantee.

**A. In General.** Under the general ISO rules, the grantee of an ISO is not taxed upon exercising the ISO. Instead, upon his or her disposition of the underlying stock, the grantee reports the amount he or she receives in the disposition less the exercise price of the ISO

as long-term capital gain. Thus, and in contrast to the NQO rules (which, again, tax the pre-exercise appreciation as ordinary income upon the exercise of the option and the post-exercise appreciation as capital gain upon the disposition of the underlying stock), the general ISO rules tax both the pre-exercise and post-exercise appreciation as long-term capital gain upon the disposition of the underlying stock.

**B. Caveats.** Unfortunately, the general ISO rules have two significant caveats that often serve to defeat the tax objectives of ISO awards.

(i) *Disqualifying Dispositions.* The first caveat is that the grantee must hold the underlying stock until at least two years after the grant of the ISO and at least one year after the exercise of the ISO. A disposition of the underlying stock before either of the holding periods has run (referred to as a "disqualifying disposition") requires the grantee to report the spread on the option at the time of exercise (or, if less, the excess of the disposition price over the exercise price) as ordinary compensation income for the year of the disposition.<sup>7</sup>

(ii) *AMT.* The second caveat is that the alternative minimum tax (or "AMT") rules accord no special treatment to ISOs. Thus, the grantee must include the spread on the ISO at the time of exercise in computing his or her alternative minimum taxable income for the year of exercise. Depending on the size of the spread and the grantee's other adjustments and preferences, the AMT rules can subject the grantee to tax for the

<sup>6</sup> Because vesting provisions may have (or at least in the past have had) an effect on the granting corporation's financial reporting, it is generally a good idea for the corporation to seek the input of its accountants before implementing a plan.

<sup>7</sup> In the case of a disqualifying disposition of the stock to a third party, any amount by which the disposition price exceeds the value of the stock on the date of the exercise of the option is generally taxable as capital gain for the year of the disposition. If the disposition price of the stock is less than the exercise price of the option, the grantee has no income from the disqualifying disposition but instead reports a capital loss equal to the excess of the exercise price over the disposition price.

year of exercise at the AMT rate on some portion of the spread at the time of exercise.<sup>8</sup>

**C. Still Preferable to Grantee.** Despite the caveats, employees generally prefer ISOs to NQOs. Again, the exercise of a NQO generally requires the grantee to report the spread upon exercise as ordinary compensation income for the year of exercise. The exercise of an ISO not followed by a disqualifying disposition is generally a tax event only for purposes of the AMT. Any AMT payable as a result of the exercise of an ISO is likely to be less than the regular tax liability resulting from the exercise of a NQO with the same spread because of the lower AMT rates and the way the AMT is calculated. If the employee makes a disqualifying disposition, he or she must report the spread upon exercise as ordinary compensation income (i) for the year of the disposition rather than for the year of the exercise and (ii) net of any amount by which the disposition price is less than the value of the stock as of the time of exercise (if the option were a NQO, any such recognized post-exercise depreciation would likely have been a capital loss rather than an offset against ordinary compensation income).<sup>9</sup>

### 3. Treatment of Corporation.

A corporation that grants an ISO reports no compensation deduction with respect to the ISO unless the grantee makes a disqualifying disposi-

tion. Upon a disqualifying disposition, the corporation deducts the compensation income reported by the grantee subject to any applicable deductibility limitations and the compliance by the corporation with applicable reporting rules.

### III. Restricted Stock

As an alternative to options, corporations sometimes offer restricted stock to service providers. As used in this outline, the term “restricted stock” means stock that the corporation issues at the outset to a service provider and that is “substantially nonvested.” Stock is “substantially nonvested” for as long it is both subject to a “substantial risk of forfeiture” and “non-transferable.” Stock is subject to a “substantial risk of forfeiture” for as long as it is subject to repurchase at a price less than its fair market value (typically, the repurchase price is the service provider’s cost) if the service provider ceases to perform substantial services (or if there is otherwise a failure of a condition related to a purpose of the transfer).<sup>10</sup> Stock is non-transferable for as long as it may not be transferred free of a substantial risk of forfeiture.

Thus, restricted stock can be made subject to the same time or performance based vesting conditions as might apply to options (and can also be made subject to repurchase by one or more of the other shareholders in addition to or instead of the corporation). In

the case of an option, “vesting” permits the grantee to exercise the option and thereby purchase the underlying stock at a price fixed on the grant date. If the corporation retains any right to repurchase stock purchased by the grantee by exercising the option, the repurchase price is typically the fair market value of the stock at the time of the repurchase (or some formula price intended to approximate fair market value).<sup>11</sup> In the case of restricted stock, “vesting” generally terminates the obligation of the recipient to sell the stock back to the corporation at a price that is less than fair market value.<sup>12</sup> Thus, “vesting” in each case establishes the right of the service provider to receive any value of the stock in excess of the price established at the outset. The difference between the two approaches is that, under a restricted stock arrangement, the stock is actually issued to the service provider up front subject to a right of the corporation to repurchase the stock at a price less than fair market value (again, typically the service provider’s cost) if the service provider fails to vest.<sup>13</sup>

The tax consequences of a restricted stock award generally depend on whether or not the recipient makes an election under Section 83(b) (a “Section 83(b) election”) with respect to the stock.

**Section 83(b) Election.** On the one hand, the recipient may make a Section 83(b) election with respect to

<sup>8</sup> Currently, the maximum AMT rate applicable to individuals is 28%.

<sup>9</sup> ISOs are also not subject to the provisions of Section 409A. Of course, ISOs have their own exercise price requirement, which, as a practical matter, may require the same type of valuation required to ensure that NQOs are not subject to Section 409A.

<sup>10</sup> For stock to be substantially nonvested, the possibility of forfeiture must be substantial if the condition is not satisfied. As an example, Section 1.83-3(c)(2) of the Regulations provides that stock is not subject to a substantial risk of forfeiture if it may be repurchased at less than fair market value only if the service provider is terminated for cause or for committing a crime.

<sup>11</sup> It is possible to structure arrangements in which service providers are granted options to purchase shares that are subject to vesting. A discussion of these types of arrangements, particularly arrangements where ISOs are exercisable for restricted stock, is beyond the scope of this outline. It should be noted that such arrangements may present certain issues (such as issues regarding holding periods) that are not apparent from this outline.

<sup>12</sup> Technically, vesting occurs when the stock becomes either (i) no longer subject to a substantial risk of forfeiture or (ii) transferable (free of a substantial risk of forfeiture).

<sup>13</sup> Because of the additional complexity, corporations often hesitate to make restricted stock available to as broad a pool of employees and contractors as might participate in an option plan.

the stock. In that case, upon his or her receipt of the stock (receipt being the compensation event for tax purposes), he or she reports any excess of the then value of the stock (without regard to the service related restrictions) over the amount he or she pays for the stock as ordinary compensation income.<sup>14</sup> He or she takes a fair market value basis in the stock, and his or her holding period begins. He or she then suffers no tax consequences upon vesting. Instead, if he or she vests, he or she reports capital gain upon selling the stock equal to the amount he or she receives in the sale less his or her basis in the stock (so that all of the post-issuance appreciation is capital gain upon the disposition of the stock). If he or she forfeits the stock by failing to vest, however, his or her loss (which is generally a capital loss) is limited to the excess, if any, of the amount he or she paid for the stock over the amount he or she receives upon forfeiting the stock (thus, he or she is not entitled to recoup any income he or she reported upon receiving the stock by taking a corresponding deduction upon forfeiture).<sup>15</sup>

**No Section 83(b) Election.** On the other hand, the recipient may forego making a Section 83(b) election. In that case, he or she reports ordinary income when (or as) the stock vests equal to the excess of the value of the vested stock at the time it vests over the amount he or she paid for the vested stock (so that vesting is the compensation event, and the appreciation between the time of issuance and the time of vesting is ordinary income at the time of vesting).<sup>16</sup> His or her initial basis in the vested stock becomes the fair market value of the stock, and his

or her holding period begins, at the time of vesting.

**Election Considerations, Timing and Mechanics.** A Section 83(b) election is often a good idea if the recipient believes (i) that the stock is likely to appreciate in value to a significant extent and (ii) that he or she is likely to vest. Of course, the recipient will need to weigh the benefits of the election against any tax he or she might owe upon receiving the stock as a result of making the election (and the consequences of any subsequent forfeiture of the stock). To be effective, a Section 83(b) election must be filed with the IRS by the recipient within thirty days after his or her receipt of the stock. The recipient must also provide the corporation (and others in certain instances) with a copy of the election and attach another copy to his or her tax return for the year of his or her receipt of the stock.

Particularly if the stock value is low at the time the award is to be made, a restricted stock award coupled with a Section 83(b) election can provide the recipient with a better tax result than an option award. In that case, the restricted stock award allows the recipient to report all of the post-issuance appreciation in the value of the stock as capital gain (long-term if he or she holds the stock for more than a year) when he or she disposes of the stock at a minimal up-front cost (in terms of purchase price, tax or some combination of the two).<sup>17</sup> If the value of the stock is high at the time the award is to be made, however, the up-front cost (or, if the recipient will forego making a Section 83(b) election, consequences

of vesting) of a restricted stock award may cast the option alternative in a more favorable light.

**Treatment of Corporation.** Subject to any applicable limitations and the compliance with applicable reporting rules, the corporation's compensation deductions mirror the recipient's compensation income in both amount and timing.

**Practical Issues.** The use of restricted stock may raise a number of practical issues, including the following:

- If restricted stock has significant value upon its issuance, the recipient may want the issuing corporation to lend him or her the purchase price for the stock to avoid having to pay anything out of pocket upon receiving the restricted stock. So that he or she is not at risk for the loan from the corporation, the recipient may want the corporation to have the right only to take the stock back if he or she defaults (without recourse to any other assets of the recipient). If the recipient borrows the purchase price from the corporation and is not personally liable for a "substantial portion" of the debt, however, the IRS may attempt to treat the recipient as having only a NQO.<sup>18</sup> In addition, any subsequent amounts by which the recipient's debt is forgiven are likely to be ordinary income to the recipient when forgiven (and not eligible for the "purchase price adjustment" exception of Section 108(e)(5) of the Code on account of their being in the nature of compensation income rather than income from

<sup>14</sup> Technically, the fair market value is determined taking into account only restrictions which by their terms will never lapse (referred to as "nonlapse restrictions"). An example of a nonlapse restriction is an obligation to sell the stock at a formula price under a buy-sell agreement.

<sup>15</sup> The consequences of the forfeiture rule may be even more significant if the corporation is an S corporation and the recipient has had to report a share of the corporation's income without receiving a corresponding tax distribution.

<sup>16</sup> Again, fair market value is determined taking into account only restrictions which by their terms will never lapse.

<sup>17</sup> Restricted stock is also attractive in that it is generally not subject to the rules of Section 409A (regardless of whether or not the recipient makes a Section 83(b) election).

<sup>18</sup> See Regulations Section 1.83-3(a)(2).

the cancellation of indebtedness).

Arrangements that obligate the corporation to repurchase the stock can undermine the tax objectives sought in using restricted stock.

- Often, restricted stock is issued to a service provider solely to accommodate the service provider's tax objectives. If not for the tax laws, the corporation would have granted options to the service provider to condition the service provider's right to hold shares on the satisfaction of vesting requirements. For state law purposes, however, the recipient is a shareholder despite the fact that he or she might not yet have fully "earned" the shares held by him or her. Issues may arise as to the extent to which the recipient is to be accorded rights of a shareholder under a shareholders' agreement. In addition, consideration is often given to whether voting agreements or other arrangements with respect to the voting of non-vested shares are appropriate.
- If the recipient does not make a Section 83(b) election, he or she is not deemed to own the stock for tax purposes until vesting.<sup>19</sup> Any distributions made to him or her with respect to the stock before vesting are treated as compensation payments. If the corporation is an S corporation, the recipient does not report any of the corporation's undistributed income, even though he or she might be entitled to receive a share of the income if later distributed. It is not unusual, therefore, for S corporations to require recipients of restricted stock to make Section 83(b) elections.

*This article is not intended to constitute legal or tax advice and cannot be used for the purpose of avoiding penalties under the Internal Revenue Code or promoting, marketing or recommending any transaction or matter addressed herein.*

<sup>19</sup>. Absent a Section 83(b) election, the shares are not treated as being outstanding for S corporation qualification purposes until they have vested.

