



Stock Options and Restricted Stock

By Charles A. Wry, Jr.



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The tax consequences of an equity compensation award may vary significantly depending on how the award is structured. In general, the goal of the award recipient is to defer his out-of-pocket purchase price and tax costs related to the award for as long as possible and to maximize the portion of his income from the award that is taxable at long-term capital gain rates.ⁱ 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 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 article reviews the requirements and tax treatment of three forms of equity based compensation: options that are not ISOs (“non-qualified stock options” or “NQOs”), ISOs and restricted stock.

I. NQOs

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”).ⁱⁱ The grantee then receives the underlying stock with a fair market value basis and a holding period beginning on the date of exercise.ⁱⁱⁱ 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 holds the stock for more than a year after exercising) upon the disposition of the stock.

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 if it properly reports the grantee’s compensation income on a Form W-2 or 1099, as the case may be. The corporation must also withhold and pay employment tax with respect to the grantee’s compensation income if the grantee is an employee.

II. ISOs

An option may qualify as an ISO only if:

- It is granted pursuant to a plan that (i) specifies the aggregate number of shares that may be issued and the employees or class 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 from 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 the granting corporation (or of a parent or subsidiary corporation) 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.^{iv}

Under the general ISO rules, the grantee of an ISO is not taxed upon exercising the ISO. Instead, upon his disposition of the underlying stock, the grantee reports the amount he 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. The corporation granting the ISO reports no compensation deduction with respect to the ISO. Unfortunately, the general ISO rules have two significant caveats that often serve to defeat the tax objectives of ISO awards.

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 the holding period has run (referred to as a "disqualifying disposition") requires the grantee to report ordinary compensation income for the year of the disposition equal to the spread on the option at the time of exercise.^v 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.

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 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 year of exercise at a maximum rate of 28% on some portion of the spread at the time of exercise.

Despite the caveats, employees generally prefer ISOs to NQOs. If an employee exercises an ISO but then makes a disqualifying disposition, he is taxed at ordinary income rates on the spread measured at the time of exercise just as he would have been had the option been a NQO. That spread, however, is income for the year of the disqualifying disposition, which may be the year after the year of exercise. Further, any AMT liability resulting from 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 upon exercise.^{vi}

III. Restricted Stock

As an alternative to options, corporations sometimes offer restricted stock to service providers. As used in this article, the term “restricted stock” means stock that the corporation issues at the outset to a service provider subject to a right of the corporation to repurchase the stock at the service provider’s cost (or some other amount that is less than fair market value at the time of repurchase) if specified service related vesting conditions are not met.^{vii} Restricted stock can be made subject to the same time or performance based vesting conditions as might apply to options. 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). 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. 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 the service provider’s cost if the service provider fails to vest.^{viii}

A recipient of restricted stock generally has two choices for tax purposes. On the one hand, he may make a “Section 83(b) election” with respect to the stock. In that case, upon his receipt of the stock (receipt being the compensation event for tax purposes), he reports any excess of the then value of the stock (without regard to the service related restrictions) over the amount he pays for the stock as ordinary compensation income. He takes a fair market value basis in the stock, and his holding period begins. He then suffers no tax consequences upon vesting. Instead, if he vests, he reports capital gain upon selling the stock equal to the amount he receives

