Morgan Stanley

WEALTH MANAGEMENT

Executive Compensation: Stock and Stock Options

Stock Options/Executive Compensation

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Executives today are increasingly compensated with stock or stock options. A benefit of receiving stock or stock options is that they allow the employee to share in the growth of the company without making a current investment (by purchasing stock or exercising options). However, exercising stock options presents a number of difficult—and sometimes divergent—choices. Accordingly, it is critical that an executive understand the risk of investing financial assets and the potential reward of preferential federal income tax treatment. The following is a general overview of some of the basic federal income tax rules applicable to stock and stock options. Additional rules and exceptions may apply. Executives should always consult their personal tax advisors regarding the tax consequences of stock compensation.

Stock Options

There are two types of employee stock options, qualified or statutory stock options (also referred to as incentive stock options (ISOs)), which receive preferential tax treatment, and non-qualified stock options (NQSOs), which do not.

NQSOS:

- The grant of a NQSO that does not have a readily ascertainable fair market value at the time the option is granted (which is usually the case unless such option is actively traded on an established market) is not taxable to the employee at the time of grant.
- The vesting (becoming exercisable) of a NQSO is generally not a taxable event.
- When the employee exercises a NQSO, the difference between the fair market value of the stock at the time of exercise and the exercise price (the spread) is taxed as ordinary income (subject to withholding tax) and reported on Form w-2
- The employee's tax basis in the acquired shares is the fair market value of the stock at the date of exercise.
- The employee's holding period of the stock for federal capital gain (or loss) tax purposes commences on the exercise of the option.
  - After the exercise of an NQSO, any future appreciation (or depreciation) in the stock will be taxed as short- or long-term capital gain (or loss) on a subsequent sale, depending on its holding period.

ISOs:

- An employee does not recognize ordinary income when the ISO is granted, vests or is exercised.
- For a stock option to qualify as an ISO, it must meet a number of requirements. Among others[1] :
  - The option can only be transferred to another beneficial owner upon death of the employee and cannot be exercised by any person other than the employee during his or her life.
    - If the number of ISOs which become exercisable for the first time by any one individual during any calendar year exceeds $100,000 of the fair market value of the stock on the date of the grant, then the options over that threshold will be treated as NQSOs. This means that, regardless of when and how many options are actually exercised, the maximum number of ISOs that can become exercisable in any one year (and still be treated as ISOs) is equal to $100,000 divided by the exercise price of the options granted (accounted for in the order in which they were granted).
  - Example: If an employer grants 1,000,000 immediately exercisable options to an employee on December 31st when the stock price is $1 per share, only the first 100,000 options can qualify as ISOs ($100,000 divided by $1). The remaining 900,000 options would be treated as NQSOs.
    - The $100,000 limitation is based on the number of options that become exercisable in a calendar year, not the amount actually exercised.
- Unlike an NQSO, when an employee exercises an ISO the spread is not subject to federal ordinary income tax; however, the spread is treated as an adjustment item for purposes of calculating the employee's alternative minimum tax (AMT).
  - AMT may be generated in the year ISOs are exercised (though generally payable by April 15 of the following year) and a credit for most of the AMT paid may be available for use in future years to offset the

Notes:
[1] An ISO may only be issued to an employee; the optionee must remain an employee at all times from grant until exercise or must exercise their ISOs within three months after terminating employment (one year in the case of termination due to death or disability); the option must be exercisable for no more than 10 years from the date of grant; the exercise price must not be less than the fair market value of the stock on grant; and the employee cannot own more than 10% of the combined voting power of all classes of stock of the corporation (unless the option exercise price is at least 110% of the fair market value of the stock at the time of grant and the option is exercisable for no more than 5 years from the date of grant).

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employee's regular tax liability. This credit is available only under certain conditions, which may occur in the year the stock is ultimately sold. Careful planning is required to mitigate or avoid potential adverse AMT consequences.

  - ISOs can sometimes be "early exercised" or exercised prior to vesting, followed by making an Internal Revenue Code Section 83(b) election, discussed in detail below. The potential benefit of doing so is to limit the amount of the ISO exercise as an AMT preference item in hopes of minimizing or avoiding entirely the application of the AMT.

- The basis of the acquired shares for federal income tax purposes is the exercise price.
- The basis of the acquired shares for AMT purposes is the exercise price increased by the AMT adjustment.
  - The tax advantage of an ISO is that the employee is not required to recognize income upon exercise of an ISO. In addition, the positive spread between the ultimate selling price of the stock and the exercise price will generally be treated as a long-term capital gain if the shares are sold more than two years after the date of grant and one year after the date of exercise. ISOs do not receive this special tax treatment if a "disqualifying disposition" occurs—i.e., the shares are sold in one year or less from the date the option is exercised or two years or less from the date the option was granted (the "holding period").
  - A "disposition" is, generally, any sale, exchange, gift or transfer of legal title of the stock.
  - Upon a disqualifying disposition, the ISO is generally treated as an NQSO exercised in the year of disposition[2] and if:
  - The disqualifying disposition is by a sale or exchange with respect to which a loss, if sustained, would be recognized under the Internal Revenue Code, then a special rule limits the ordinary income recognized to the positive difference between the sale price of the stock and the exercise price of the option; or
  - The disqualifying disposition is by any other means (e.g., gift), then the spread on the original exercise of the option will be treated as ordinary income in the year of the disposition, even if the sale price of the stock is less than the price of the stock on the date of exercise.
- In the calendar year of exercise, a disqualifying disposition of ISO stock may be preferred if the stock has depreciated significantly since exercise of the option.
  - In this case, the employee may have significant AMT exposure, perhaps even in excess of the value of the stock. To avoid the AMT consequences of the original exercise, the employee can sell the stock in the same calendar year as exercise and take advantage of the special rule described above which limits the ordinary income recognized to the positive difference between the sale price of the stock and the exercise price of the option.
- The tax consequences of a disqualifying disposition of shares acquired by early exercise (i.e., shares held more than one year from exercise but two years or less from grant) were somewhat unclear until the issuance of Final Regulations in late 2004. While some commentators believed the exercise of the unvested options followed by a Section 83(b) election controlled the AMT consequences and started the holding period of the shares for capital gains (or loss) purposes, the Final Regulations make clear that:
  - The Section 83(b) election will be recognized for AMT purposes but not for regular federal income tax purposes. The spread, if any, will be measured at the time of exercise.

Notes:
[2] Specifically, the spread at exercise is generally taxed as ordinary income, and any incremental gain upon disposition is treated as short-term or long-term capital gain.

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  - In general, an employee who makes a disqualifying disposition of shares acquired via early exercise of an ISO must report ordinary income equal to the fair market value of the stock on the vesting date (not the date of exercise) less the exercise price.
  - Pursuant to corrective amendments to the regulations released by the IRS on October 18, 2004, the holding period for determining capital gains (or loss) treatment with respect to the disqualified shares begins on the date of vesting and not the date of exercise (this was unclear under earlier issuance of Final Regulations).

To Exercise or Not to Exercise?

Whether an employee should exercise an option or not depends on a number of factors and should always involve the employee's accountant or attorney. Relevant considerations include:

- For NQSOs, postponing the exercise of a NQSO postpones the cash outlay and resultant ordinary income tax liability on the spread. However, exercise of the option converts subsequent gain that would otherwise be treated as ordinary income to capital gain (or loss) which may be eligible for lower rates. This is important where the stock is expected to appreciate significantly after exercise.
- For ISOs, postponing the exercise of an ISO postpones the cash outlay and any potential AMT exposure. However, exposure to the AMT generally increases with stock appreciation and postponing exercise can extend the employee's holding period of the stock needed to qualify it for capital gain (or loss) treatment.
- For NQSOs and ISOs, exercise of any option increases the employee's risk as capital is being invested in the stock that may decrease in value. This is a particularly significant concern where the employee is already heavily invested in the employer.

83(b) Election

When property (including stock) is transferred to an employee in connection with the performance of services, the employee who performed the services must recognize as ordinary income the value of the property when it is no longer subject to a substantial risk of forfeiture or becomes transferable, whichever occurs first (Internal Revenue Code Section 83(a)).

- However, employees who hold property that is both subject to a substantial risk of forfeiture and is non-transferable (e.g., restricted stock received pursuant to an outright stock award or through the exercise of an option) may still elect to recognize the value of such property as income in the year of receipt, under Section 83(b).
  - The advantage of the so-called 83(b) election is that if the stock appreciates after the election the appreciation can be taxed as capital gains rather than ordinary income.
  - The risks of an 83(b) election include the fact that the employee may recognize income at the time of the election but will not have received cash or shares to pay the tax and if the property subsequently declines in value the employee may have nothing to sell or show for the federal income tax paid except a potential capital loss.
  - If the employee forfeits the property after the 83(b) election is made and income is recognized, the employee will have a capital loss (but only to the extent of any amount paid for the stock), which he or she may not be able to use.

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A Note on Transfer Taxes

Prior to 1998, estate and gift (transfer) tax savings could be achieved by making a gift of NQSOs, vested or not, shortly after grant when the intrinsic value of the option was low. (ISOs cannot be transferred by gift or sale during life.) The options would later be exercised with the employee taxed on the spread (in effect, making an additional tax-free gift to the donee). All appreciation after the gift would thus escape transfer tax.

- In 1998, the IRS ruled that a gift of an option that is not yet vested (because the employee has yet to perform services) is not a completed gift. The gift is considered complete when the employee no longer has to perform services to exercise the option, i.e., it vests. Thus, the gift tax impact will be determined when the option most likely has value.
- Taxpayers must now value gifts of vested options for transfer tax purposes. In general, the valuation is provided by an option pricing model such as Black-Scholes or the like that takes into account the exercise price, the expected life of the option, the stock's trading price, volatility, dividends, and the risk-free rate of return.

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