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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 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 income tax treatment. The following is a general overview of some of the basic rules applicable to stock and stock options[1]

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.

Notes:
[1] Additional issues to consider include the methods of financing any stock option exercise or stock purchase and any tax liabilities due, even prior to sales of shares.

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) is not taxeable to the employee at the time of grant.
- The vesting (becoming exercisable) of a NQSO is not a taxable event.
- When the employee exercises a NQSO (purchases the underlying shares), than difference between the then fair market value of the stock at the time of this exercise and the exercise price (the spread) is treated as compensation and taxed as ordinary income (and subject to withholding).
- The employee's tax basis in the acquired shares is the fair market value of the stock on the date of exercise.
- The employee's holding period of the stock for federal capital gains tax purposes commences on the date of exercise of the option.
  - After the exercise of an NQSO, any future appreciation (or depreciation) in the stock will be taxed as capital gain (or loss) on its later sale, short- or long-term depending on its holding period.

ISOS:

- For a stock option to qualify as an ISO, it must meet a number of requirements. Among others[2] :
  - The option can only be transferred to a “grantor trust” (for example a revocable trust in which the employee is the sole beneficial owner and under which the option would continue to be taxable income to the employee, or 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 one calendar year exceeds $100,000 of the fwir 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 (accounted for in the order in which they were granted).
    - Example: If an employer grants 1,000,000 immediately exercisable ISOs to an employee on December 31 when the stock price is $1 per share, only the first 100,000 ($100,000 divided by $1) options can qualify as ISOs. 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.
- An employee does not recognize ordinary income when the ISO is granted, vests or is exercised[3] .
- Unlike an NQSO, when an employee exercises an ISO the spread is not subject to ordinary income tax; however, the spread is treated as an

Notes:
[2] An ISO may only be issued to an employee; the optionee must remain an employee at all times from grant under 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).

[3] There is no Federal withholding for FICA and FUTA for ISOs exercised after October 22, 2004, whether stock is sold under ISO rules or through disqualifying disposition.

adjustment item for purposes of calculating the alternative minimum tax (AMT).

- AMT may be generated in the year ISOs are exercised (though generally payable by April 15th of the following year) and a credit for most [4] of the AMT paid may be available against for use in future years to offset the 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 potentially adverse AMT consequences.
- ISOs can sometimes be "early exercised" or exercised prior to vesting, followed by making an Internal Revenue Code (Code) section "83b 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 regular 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 the 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. "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[5] and if:
    - The disposition is by a sale or exchange with respect to which a loss, if sustained, would be recognized under the 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, even if the sale price of the stock is less than the price of the stock on the date of exercise 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.
- An employee may consider selling an ISO stock before the holding period has been met. If the stock has depreciated significantly since exercise of the option in the calendar year of exercise.
  - 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 advantage of the special rule which limits the ordinary income recognized to the positive difference between the sales price of

Notes:

[4] Not necessarily all because of the discrepancy in tax rates (26% or 28% AMT vs. 0%, 15%, or 20% long-term capital gains rates) and other factors involved in the computation of the AMT.

[5] 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.

the stock and the exercise price of the option[6] .

- The tax consequences of a disqualifying disposition of shares acquired by early exercise (i.e., shares held more than 1 year from exercise but less than 2 years from grant) were somewhat unclear until the issuance of Final Regulations [7] in late 2004. While some commentators believed the exercise of the 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 income tax purposes. The spread, if any, will be measured at the time of exercise.
  - 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 184, 2004, the holding period for determining capital gains (or loss) treatment with respect to the disqualified ISOs 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 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 be decease in value. This is a particularly significant concern where the employee is already heavily invested in the employer.

Stock

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 section 83(a) of the Code)[8].

- 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 elect (under section 83(b)) to recognize the

Notes:

[6] If the employee repurchases the stock, or otherwise enters into a contract (including an option) to purchase the stock, in the 30 day period before or after the sale of the ISO stock, he or she may have a non-deductible loss for AMT purposes through the application of the wash sale rules (meaning the AMT will not be avoided).

[7] The Final Regulations diminished the potential advantages of early ISO exercise and may have led to more frequent use of NQSOs instead of ISOs.

[8] Note that a grant of restricted stock units is generally not considered a transfer of property until the stock underlying the units is delivered to the employee

value of the property as income before the restrictions lapse.

- The advantage of the so-called section 83(b) election is that if the stock appreciates after the election the appreciation can be taxed as capital gains rather than ordinary income.
- Risks of the section 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 will have nothing to show (or sell) for the income tax paid except a potential capital loss.
  - If the employee forfeits the property after the section 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.

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 complete. The gift is considered complete when the employee no longer has to perform services to exercise the option, i.e., it vests. Gift tax will thus be assessed when the option most likely has value.
- Taxpayers must now value gifts of vested options for transfer tax purposes, in general, using 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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