Stock Option Tax Rules Business Lawyers Should Know

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Employees who work for a salary and a cash bonus may not know much about stock options or restricted stock. But lawyers representing employees (or independent contractors) with these increasingly important forms of compensation should know the sometimes confusing tax rules that apply to stock-related compensation. 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 for candidates to join. In many jobs, the biggest paydays are from equity, not from cash.

Executives, rank and file workers, and even consultants might be offered stock or options in lieu of, or in addition to, their cash compensation. Even outside lawyers and other consultants can get a piece of the action, since non-employees (meaning independent contractors) sometimes receive options or restricted stock, too.

All of them may need advice. If a company offers your client restricted stock or stock options, then there can be tax and economic advantages to accepting this equity, but there can also be tax traps. And your client might not know that he or she walked into a trap until years later.

Incentive Stock Options

Let's start with stock options. There are two types of stock options that are issued as compensation for services, and the tax rules that apply to them are quite different. There are incentive stock options (also called ISOs) and non-qualified stock options (also called NSOs).[1] Some employees receive both. Your client's plan (and each individual option grant) should expressly state which type of option is being granted.

ISOs are taxed the most favorably. There is generally no tax at the time they are granted.[2] There is also no "regular" tax at the time they are exercised.[3] Thereafter, when the holder sells shares acquired on exercise of the option, he or she will pay tax, hopefully as a long-term capital gain.[4]

But be careful. The usual long-term capital gain holding period is more than *one* year.[5] However, to get long-term capital gain treatment for shares acquired via ISOs, the recipient must: (a) hold the shares for more than a year after exercising the options; and (b) sell the shares at least two years after the ISOs were granted.[6] The latter, two-year, rule catches many people by surprise.[7]

Beware of AMT

Again, when one exercises an ISO, there is no "regular" tax. But there could be an *irregular* tax, known as the alternative minimum tax, usually abbreviated to AMT.[8] 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 AMT. Note that one does not generate cash when exercising ISOs, because only shares of stock are acquired. If your client owes AMT, he or she will have to use *other* funds to pay the AMT. Alternatively, one can arrange to sell enough stock when exercising 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 each underlying share is worth $20, she exercises, paying $10 per share. The $10 spread between her exercise price and the $20 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, clients should run the numbers, and get some advice. If the stock crashes before the holders sell, then they 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. In the recent tax reform legislation, the House version of the bill proposed repealing the AMT for individuals. However, the final bill retained the AMT, albeit with temporarily higher exemption amounts.

Nonqualified Options

The other type of stock options are nonqualified options, or NSOs. Because of conditions and limits on ISOs, executives are more likely to receive all (or at least most) of their options as non-qualified options.[9] 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.

Moreover, NSOs offer some planning possibilities that ISOs do not. As with ISOs, there is no tax at the time the option is granted.[10] But when one exercises a nonqualified option, one owes ordinary income tax (and, for employees, Medicare and other payroll taxes) on the difference between the option exercise price and the fair market value of the underlying shares at the time of exercise.[11]

> 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 per share when he exercises, but the value at that time is $10 per share, so he has $5 of compensation income for each share exercised. 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 a person exercise and immediately sell the acquired shares. In fact, an executive or employee who expects future appreciation in the shares might not *want* to sell. With an NSO, one can exercise and then hold the shares acquired. One only must hold the stock only for more than a year to get long-term capital gain treatment on any additional appreciation post-exercise.[12]

Stock Bonuses and Restricted Stock

What if the deal your client is offered doesn't say anything about options? Some workers are given, or "bonused," stock that their employment contracts do not provide for. In some cases, they might be offered the chance to *buy* stock. In either case, there are probably going to be employment-related restrictions attached to that stock.

If a worker receives stock (or any other property) from their employer with conditions attached (say, they must stay for two years to get it, or to keep it), special restricted property rules apply under § 83 of the Internal Revenue Code.[13] 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 that if he remains with the company for thirty-six months, then 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 thirty-six months to see what will happen. When Sam receives the stock, he has income measured by the value of the stock when he receives it. That might be more or less than $50,000, depending on how the shares have done in the interim. This income is taxed as wages, which means that 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 determining that tax is due.[14] 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, meaning it takes the restrictions into account.[15]

> Example: Betty's employer promises her stock if she remains with the company for eighteen

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 would be much higher without those restrictions. But under the buy/sell agreement, Betty would have to sell the shares back to the company for $20 per share if Betty ever leaves the company's employment. The IRS will wait and see if Betty stays for the first eighteen months (so as not 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 per share resale price. That means she will probably be taxed on $20 of compensation per share.

New Election to Defer Income

Under normal tax rules, employees generally must recognize income in the taxable year in which the employee's right to restricted stock is transferable or is no longer subject to a substantial risk of forfeiture, whichever occurs earlier.[16] However, under the recent tax reform legislation, some employees can elect to defer the recognition of income for restricted stock for up to five years. The new "§ 83(i) election" may allow some (but not all) employees to file an election with the IRS within thirty days of when the restricted stock vests (and would normally be included in the employees' incomes).[17]

Although there are still a number of questions regarding which employees and what restricted stock may qualify for this election, it is clear that not all employees qualify to make the new § 83(i) election. One-percent owners of the issuing corporation, the current or prior CEO or CFO, and some highly compensated officers, are "Excluded Employees" under the new § 83(i).[18] Excluded Employees are not eligible to make § 83(i) elections.

There are also limitations and requirements that can deny the election to employees based on features of the stock plan and features of the corporation involved with the election. For companies that have already implemented restricted stock plans and restricted stock options, navigating these requirements may be particularly difficult. Start-ups, however, may be in a better situation to design their plans to qualify for the new election.

Even so, the new election is not likely to be available for many of the initial founders of a start-up. They are more likely to be considered Excluded Employees because of their stock ownership, titles, and/or compensation. For employees who are eligible to make an 83(i) election, those employees may be able to defer the recognition of income on the restricted stock until the *earliest* of: (1) the date the restricted stock becomes transferrable; (2) the date the employee becomes an Excluded Employee; (3) the date the corporation's stock goes public; (4) the date the employee revokes the election; and (5) five years from date the restricted stock originally vested.[19]

Electing to be Taxed Sooner?

Most tax planning involves pushing off taxable events into the future. Taxpayers generally want to *postpone* income tax recognition events. Conversely, taxpayers generally want to *accelerate* tax deductions. Therefore, it may sound counterintuitive to *elect* to include something on a 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, taxpayers are allowed to *elect* to include the value of restricted property in their income *earlier* (in effect disregarding the restrictions). Why might this be a desirable strategy?

Recipients 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, recipients can choose to include the value of the property in their income earlier, even though there are restrictions. To elect current taxation, one must file a written 83(b) election with the IRS within thirty days of receiving the property.

One must report on the election the value received as compensation (which might be small or even zero). Another copy of the 83(b) election must be attached to the person's tax return for that year.

> Example: Sallie is offered stock by her employer at $5 per share when each share is worth $5. However, she must remain with the company for two years to be able to sell the shares. 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 § 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 that 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 § 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 a person pays fair market value for the stock, if he or she would not have been offered the stock but for their employment, then the stock is compensatory. There is no harm when they receive the stock, since the fair market value and the price they 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!), then the IRS can say that *all* of Sallie's gain is ordinary, not capital.[20]

Note that there is another effect of the § 83(b) election. The most obvious impact of the election is 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 sell the shares back to the company if he leaves its employ within the next seven years. There is no market for the stock, but $2 represents the price the company believes each share is worth. Niles buys his stock for $2 per share and makes a § 83(b) election reporting zero income. He holds the shares, and seven years later the shares are worth $60 per share. Then, three years after that (so ten 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 § 83(b) election when he buys the stock? Here, Niles buys his stock for $2 per share as before, but files no election. As a result, when the resale restrictions on his shares lapse at the end of year seven, 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, or $60 per share. That means Niles has $58 of wage income at the end of year seven, 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 holders and their advisers must consider *both* sets of rules. For example, your clients may be awarded stock options (either ISOs or NSOs) that are restricted, where their rights "vest" over time if they stay with the company. The IRS generally waits to see what happens in such a case.

For example, say that an employee must wait two years for the options to vest. In that case, there's no tax until that vesting date. Then, the stock option rules, which hinge on exercise, take over. At that point, the employee 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 one is 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.[21] 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."[22]

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, then 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, as well as 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) that 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.[23]

If the option fails any one of these tests, the irrebuttable presumption means that the holder is stuck with ordinary income treatment upon exercising the option.

Tax Advice

Many companies that offer stock options or other incentives try to look out for the interests of participants. After all, stock options and similar incentive plans are adopted to engender loyalty, as well as to provide incentives. Some companies provide support and explanations, and even will help participants work through their questions.

However, plan participants may still want to hire a professional to help them deal with these issues. The tax rules are complicated, especially for those having 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 to review the documents the company provides. Lawyers and clients should read them. Lawyers should ask their clients to provide copies of all their paperwork. That paperwork should include the company's plan documents, any agreements they signed that refer in any way to the options or restricted stock, and any grants or awards. If the worker actually got stock certificates, then review those, too.

Beware Section 409A

Finally, beware of section 409A of the tax code. It provides that some compensation deferred 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 grant.[24] A shorthand way of referring to them is options that are "in the money" when they are granted. Executives and other workers facing this situation should get some advice. Companies can avoid this issue by pricing options at the fair market value of the stock when the options are issued.

In addition to the risk presented by section 409A, workers facing an acceleration, cashing out, or modification of options can face extra tax risks, as might occur on a merger or on severance. Executives, the rank and file, and even some consultants can all benefit from options. But both they—and their lawyers—should be careful.

Endnotes

1 *See* I.R.C. § 422; Treas. Reg. § 1.83-7.

2 *See* I.R.C. § 422(a).

3 *See* § 422(a)(1).

4 *See* § 1222.

5 *See* § 1222(3).

6 *See* § 422(a)(1).

7 *See id*.

8 *See* § 55.

9 In particular, only the first $100,000 that becomes exercisable during any twelve-month period can qualify for ISO treatment. *See* Treas. Reg. § 1.422-4.

10 *See* § 1.83-7(a).

11 *See id.*

12 *See* I.R.C. § 1222(3).

13 *See* 26 U.S.C. § 83.

14 See I.R.C. § 83(a)(2).

15 *See* § 83(d).

16 *See* § 83(a)(2).

17 *See* Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13603 (2017).

18 *See* I.R.C. § 83(i)(3)(B).

19 *See* § 83(i)(1)(B).

20 For proof of this disastrous result, *see* L.J. Alves, 734 F.2d 478 (9th Cir. 1984).

21 *See* Treas. Reg. § 1.83-7(a).

22 *See* § 1.83-7(b).

23 § 1.83-7(b)(2).

24 *See* I.R.S. Notice 2005-1.