The Tax Lawyer

Ten Tax Tips For Stock Options

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If your company offers you restricted stock, stock options or certain other incentives, listen up. There are huge potential tax traps. But there are also some big tax advantages if you play your cards right.

Most companies provide some (at least general) tax advice to participants about what they should and shouldn't do, but it is rarely enough. There is a surprising amount of confusion about these plans and their tax impact (both immediately and down the road). Here are 10 things you should know if stock options or grants are part of your pay package.

1. There are two types of stock options.

There are incentive stock options (or ISOs) and non-qualified stock options (or NSOs). Some employees receive both. Your plan (and your option grant) will tell you which type you are receiving.

ISOs are taxed the most favorably. There is generally no tax at the time they are granted and no "regular" tax at the time they are exercised. Thereafter, when you sell your shares, you will pay tax, hopefully as a long-term capital gain. The usual capital gain holding period is one year, but to get capital gain treatment for shares acquired via ISOs, you must: (a) hold the shares for more than a year after you exercise the options and (b) sell the shares at least two years after your ISOs were granted. The latter, two-year rule catches many people unaware.

2. ISOs carry an AMT trap.

As I noted above, when you exercise an ISO you pay no "regular" tax. That might have tipped you off that Congress and the IRS have a little surprise for you: the alternative minimum tax. Many people are shocked to find that even though their exercise of an ISO triggers no regular tax, it can trigger AMT. Note that you don't generate cash when you exercise ISOs, so you will have to use other funds to pay the AMT or arrange to sell enough stock at time of exercise to pay the AMT.

Example: You receive ISOs to buy 100 shares at the current market price of $10 per share. Two years later, when shares are worth $20, you exercise, paying $10. The $10 spread between your exercise price and the $20 value is subject to AMT. How much AMT you pay will depend on your other income and deductions, but it could be a flat 28% AMT rate on the $10 spread, or $2.80 per share.

Later, it you sell the stock at a profit, you may be able to recover the AMT through what's known as an "AMT credit." But sometimes, if the stock crashes before you sell, you could be stuck paying a big tax bill on phantom income. That's what happened to employees hit by the dot-com bust of 2000 and 2001. In 2008 Congress passed a special provision to help those workers out. (For more on how to claim that relief, click here.) But don't count on Congress doing that again. If you exercise ISOs, you must plan properly for the tax.

3. Executives get nonqualified options.

If you are an executive, you are more likely to receive all (or at least most) of your options as non-qualified options. They are not taxed as favorably as ISOs, but at least there is no AMT trap. As with ISOs, there is no tax at the time the option is granted. But when you exercise a nonqualified option, you owe ordinary income tax (and, if you are an employee, Medicare and other payroll taxes) on the difference between your price and the market value.

Example: You receive an option to buy stock at $5 per share when the stock is trading at $5. Two years later, you exercise when the stock is trading at $10 per share. You pay $5 when you exercise, but the value at that time is $10, so you have $5 of compensation income. Then, if you hold the stock for more than a year and sell it, any sales price above $10 (your new basis) should be long-term capital gain.

Exercising options takes money, and generates tax to boot. That's why many people exercise options to buy shares and sell those shares the same day. Some plans even permit a "cashless exercise."

4. Restricted stock usually means delayed tax.

If you receive stock (or any other property) from your employer with conditions attached (e.g., you must stay for two years to get it or to keep it), special restricted property rules apply under Section 83 of the Internal Revenue Code. The Section 83 rules, when combined with those on stock options, make for much confusion.

First, let's consider pure restricted property. As a carrot to stay with the company, your employer says if you remain with the company for 36 months, you will be awarded $50,000 worth of shares. You don't have to "pay" anything for the stock, but it is given to you in connection with performing services. You have no taxable income until you receive the stock. In effect, the IRS waits 36 months to see what will happen. When you receive the stock, you have $50,000 of income (or more or less, depending on how those shares have done in the meantime.) The income is taxed as wages.

5. The IRS won't wait forever.

With restrictions that will lapse with time, the IRS always waits to see what happens before taxing it. Yet some restrictions will never lapse. With such "non-lapse" restrictions, the IRS values the property subject to those restrictions.

Example: Your employer promises you stock if you remain with the company for 18 months. When you receive the stock it will be subject to permanent restrictions under a company buy/sell agreement to resell the shares for $20 per share if you ever leave the company's employ. The IRS will wait and see (no tax) for the first 18 months. At that point, you will be taxed on the value, which is likely to be $20 given the resale restriction.

6. You can elect to be taxed sooner.

The restricted property rules generally adopt a wait-and-see approach for restrictions that will eventually lapse. Nevertheless, under what's known as an 83(b) election, you can choose to include the value of the property in your income earlier (in effect disregarding the restrictions).

It might sound counter-intuitive to elect to include something on your tax return before it is required. Yet the game here is to try to include it in income at a low value, locking in future capital gain treatment for future appreciation. To elect current taxation, you must file a written 83(b) election with the IRS within 30 days of receiving the property. You must report on the election the value of what you received as compensation (which might be small or even zero). Then, you must attach another copy of the election to your tax return.

Example: You are offered stock by your employer at $5 per share when the shares are worth $5, but you must remain with the company for two years to be able to sell them. You already have paid fair market value for the shares. That means filing an 83(b) election could report zero income. Yet by filing it, you convert what would be future ordinary income into capital gain. When you sell the shares more than a year later, you'll be glad you filed the election.

7. Restrictions + options = confusion.

As if the restricted property rules and stock options rules were each not complicated enough, sometimes you have to deal with both sets of rules. For example, you may be awarded stock options (either ISOs or NSOs) that are restricted--your rights to them "vest" over time if you stay with the company. The IRS generally waits to see what happens in such a case.

You must wait two years for your options to vest, so there's no tax until that vesting date. Then, the stock option rules take over. At that point, you would pay tax under either the ISO or NSO rules. It is even possible to make 83(b) elections for compensatory stock options.

8. You’ll need outside help.

Most companies try to do a good job of looking out for your interests. After all, stock option plans are adopted to engender loyalty as well as provide incentives. Still, it will usually pay to hire a professional to help you deal with these plans. The tax rules are complicated, and you may have 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.

9. Read your documents!

I'm always surprised at how many clients seek guidance about the types of options or restricted stock they've been awarded who don't have their documents or haven't read them. If you seek outside guidance, you'll want to provide copies of all your paperwork to your advisor. That paperwork should include the company's plan documents, any agreements you've signed that refer in any way to the options or restricted stock, and any grants or awards. If you actually got stock certificates, provide copies of those, too. Of course I'd suggest reading your documents yourself first. You may find that some or all of your questions are answered by the materials you've received.

10. Beware the dreaded section 409A.

Finally, beware of one particular Internal Revenue Code section, 409A, enacted in 2004. After a period of confusing transitional guidance, it now regulates many aspects of deferred compensation programs. Any time you see a reference to section 409A applying to a plan or program, get some outside help. For more on 409A, click here.

Robert W. Wood is a tax lawyer with a nationwide practice. The author of more than 30 books including Taxation of Damage Awards & Settlement Payments *(4th Ed., 2009); he can be reached at wood@woodporter.com. This discussion is not intended as legal advice and cannot be relied upon for any purpose without the services of a qualified professional.*

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