Ins and outs of stock options and equity compensation

Understanding the structure and mechanics of a stock option or restricted stock award is a first important step in making informed decisions on how to manage these assets.

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A stock option gives the employee the right to purchase stock at a stated price, which is often equal to the value of the stock on the grant date.

Whether the founder or an early employee of a Silicon Valley startup or a corporate executive at a Fortune 500 company, equity compensation is a significant means of wealth creation for many of our clients. Most often, equity compensation takes the form of grants of stock options or restricted stock. This article provides a foundation for understanding the income tax treatment of these types of equity compensation arrangements and the planning strategies surrounding them.

Vocabulary

Before diving into tax treatment, it is important to understand the vocabulary pertaining to stock options and restricted stock grants. Stock options and restricted stock are awarded to an employee on a specified date called the grant date. A stock option gives the employee the right to purchase stock at a stated price, called the strike price. Very often, the strike price is equal to the value of the stock as of the grant date. Restricted stock awards the employee a stated number of shares of stock, subject to certain restrictions established by the granting company.

When granted, the award typically is not vested, meaning that the employee does not currently have the right to exercise the option or does not currently own the stock. The awards will vest over time. For example, a stock option grant may vest one-fourth after the first year and equally over the next three years by month, or one-thirty sixth per month. Or a restricted stock grant may vest one-third each year on the anniversary of the grant. Recently more nuanced vesting requirements have been included by a small number of pre-IPO companies for restricted stock awards. The stock will vest both with respect to the employee's longevity at the company, but also will not vest until six months after an initial public offering or acquisition by a publically traded company. The purpose of this additional vesting requirement is to prevent the employee from vesting a restricted stock grant, thereby triggering the income tax liability, before the stock is liquid. The requirements are intended to benefit the employee so that he or she does not have a big tax bill before he or she has access to the liquid cash to pay the bill.

Stock options generally also expire if unexercised after a certain period of time, typically 10 years. This means that if the employee does not exercise within the ten year window after grant, the options expire and the employee loses the right to purchase the stock at the strike price.

A stock option is described as in the money when the fair market value of the stock is greater than the strike price. A stock option is described as underwater when the fair market value of the stock is less than the strike price.

Income tax issues

The income taxation of stock options and restricted stock awards are very different. There are two different types of stock options, Nonqualified Stock Options (NQSOs) and Incentive Stock Options (ISOs). ISOs provide employees with more favorable tax treatment if shares are held for a specified period of time. However, ISOs are subject to greater restrictions, including a limitation on the value of options that may vest annually and restrictions on transfer. NQSOs are not afforded the same favorable tax treatment as ISOs, but they are subject to fewer restrictions. All stock options are NQSOs, unless the option grant award specifies that they are ISOs.

Nonqualified Stock Options

As a general rule, the grant of a NQSO is not a taxable event. In addition, when a NQSO vests there is no immediate income tax consequence to the employee. Upon exercise of the NQSO, the difference between the amount paid (the strike price) and the fair market value at exercise, called the spread, is immediately recognized as compensation by the employee, regardless of whether the stock is sold. If the company is publicly traded, the fair market value is usually determined by taking the market average between the high and the low price on the date of exercise. If the company is not publicly traded, the fair market value is determined by an appraisal obtained by the company—widely called the 409A valuation after Section 409A of the Internal Revenue Code (the "Code") which requires the company to obtain a qualified appraisal for this purpose. The spread is taxed to the employee as wages at ordinary income tax rates, as well as being subject to social security and Medicare taxes.

The stock acquired as a result of the exercise of a NQSO is taxed as any other share of stock would be. The employee's cost basis in the stock is the fair market value on the date of exercise. The holding period begins on the date the NQSO is exercised. And the tax rate on any future capital gains or losses will depend on the time period the stock is held post-exercise.

> Upon exercise of a NQSO, the difference between the amount paid and the fair market value at exercise is recognized as compensation by the employee.

Incentive Stock Options

Like NQSOs, ISOs are not taxable upon grant. But that is where the similarities end. To qualify as an ISO, the stock option award must meet specific statutory requirements, including the following:

- ISOs may only be granted to employees; they may not be granted to non-employee directors, independent contractors, or non-employee investors. The employee must exercise the option while employed or within three months of termination of employment (there are special rules in the event of disability or death of an employee).
- The strike price for the option must equal or exceed the fair market value on the date of the grant (typically the strike price will equal the fair market value upon grant). If the employee owns more than 10% of the voting stock of the company the strike price must be 110% of the fair market value on the date of grant.
- ISOs are non-transferrable other than by will or the laws of descent and distribution.
- Only $100,000 of stock (based on the strike price) may become exercisable in any calendar year. This is inclusive of all ISO grants that have been made. To the extent stock in excess of $100,000 becomes exercisable in a calendar year; the excess will be treated as NQSOs (with the most recent grants being treated as NQSOs first).

Unlike NQSOs, the exercise of ISOs is not an income taxable event (see however the discussion of alternative minimum tax treatment of ISOs below). The significant benefits of ISOs are realized if an employee meets the holding period requirements set forth in the Code. If an employee exercises an ISO and holds the stock for two years from the date of grant and one year from the date of exercise, the spread is taxed as capital gain rather than ordinary income, and is not realized until the stock is subsequently sold. The employee's cost basis in the stock is the strike price that they paid for it.

Any exercised ISO shares that are sold or disposed of prior to satisfying the holding period requirements will result in a "disqualifying disposition." If the stock is held for one year or less from exercise, the spread is treated as

compensation income, and any post-exercise gain is a short-term capital gain or capital loss. If the stock is held for more than one year from exercise but not two years from grant, the bargain element or spread is compensation income, and any post-exercise gain is considered a long-term capital gain or capital loss.

Although the exercise of an ISO is generally not a taxable event for regular income tax purposes, there are potential federal (and possibly state) AMT consequences.

ISOs and AMT

Although the exercise of an ISO generally is not a taxable event for regular income tax purposes, there are potential federal (and possibly state) Alternative Minimum Tax (AMT) consequences. The alternative minimum tax is a separate tax calculation intended to make sure that high income taxpayers are taxed at least at a 28% rate (after accounting for deductions and credits). Each year a taxpayer will first compute his or her regular tax liability. Then the taxpayer will compute his or her tax liability under the AMT—and will pay the higher of the two amounts.

The AMT calculation includes various items that are excluded under the regular tax, and disallows certain deductions that are allowed under the regular tax. The special items of income and deduction are called AMT preference items. For example, the state and local income tax deduction is an AMT preference item, meaning it is not allowed as a deduction when computing AMT tax liability.

ISO income is a preference item for AMT purposes. This means that although the spread between the strike price and fair market value upon exercise of an ISO is not taxed under the regular tax system, it is taxed under AMT. Before exercising ISOs, an employee should understand whether the exercise will subject them to AMT and what that exposure will be. Depending on the size of the grant and the spread at the time of exercise, the AMT liability could be very significant. If a taxpayer does incur AMT as a result of the exercise of ISOs, the taxpayer may be able to use a tax credit in subsequent years. The credit is generated due to the extra tax paid under AMT and will be used to reduce regular income tax if the regular income tax in a subsequent year exceeds the AMT calculated for that year.

Restricted stock

The taxation of a restricted stock award is rather straightforward. The grant of a restricted stock award is not a taxable event. It is the vesting of restricted stock that is taxable to the employee as wages at ordinary income tax rates (as well as being subject to social security and Medicare taxes). The employee will be taxed based on the fair market value of the stock that vests. Just like NQSOs, if the stock is publicly traded, the fair market value of the stock is the average between the high and low price on the date of vesting. If the stock is not publicly traded, the fair market value of the stock will be determined based on the 409A valuation. The vesting is subject to withholding, meaning that the company is obligated to withhold a portion of the award and make payment to the IRS and the state, if applicable.

Tax strategies for ISOs

Exercising a portion of ISO holdings each year, right up until the point where AMT liability is triggered is one potential strategy for ISOs. This requires an analysis to determine the taxpayer's AMT cushion, which is the difference between the tax calculated under the regular income tax rules and the tax calculated under the AMT rules. The employee should consider exercising just enough ISOs to consume the AMT cushion without triggering AMT tax liability.

Example *(All examples exclude any social security and Medicare taxes):* Bob, a Z company executive, currently owns 5,000 vested ISOs with a strike price of $20 per share. The stock is currently trading at $100 per share. His regular income tax on all income received for the year is $450,000 and his AMT is $400,000, so no AMT is due. Bob now has an opportunity to exercise ISOs with up to $178,571 of spread (the difference between the regular tax and AMT of $50,000 divided by 28%) before being subject to the AMT. With a spread per ISO of $80 per share, Bob could exercise up to 2,232 of his ISOs ($178,571 divided by $80) without being subject to AMT.

If the employee does not have an AMT cushion because they already are in AMT, the employee may consider triggering additional ordinary income so that the AMT cushion is larger, thereby allowing the exercise of more ISOs. The exercise of NQSOs is one method often used to create additional ordinary income. In other cases, particularly if the value of the stock has declined substantially from the original date of exercise, realizing ordinary income through a disqualifying disposition of previously acquired ISO shares should be considered.

The most important decision relating to employee stock options is when to exercise.

Tax strategies for NQSOs

The most important decision relating to employee stock options is when to exercise. For NQSOs, ordinary income taxation is triggered by the act of exercising. However, any post-exercise appreciation on the stock is taxed at lower long-term capital gains rates if the stock is held for more than one year. Therefore, a trade-off exists between paying a tax liability today in exchange for a lower tax rate on potential future appreciation and the benefit of deferring payment of income tax. One of the most fundamental techniques of tax management is to defer taxation—a dollar today after compounding and appreciation is presumably worth well more than a dollar in the future.

Example *(All examples exclude any social security and Medicare taxes):* Kate, a founder of private Company Y, currently owns 20,000 vested NQSOs at a strike price of $1. The current 409A valuation of the stock is $9 per share, and her current federal income tax rate is 37%. Kate expects that Company Y will go public in year 2, and hopes it will trade at approximately $20 per share after the IPO.

Scenario 1: Kate defers exercise until the second year, after the IPO, when the stock reaches $20. The spread on the options is now $19 per share ($20 minus $1). The total spread on her 20,000 options is therefore $380,000 which would result in federal ordinary income taxes of $140,600 upon exercise ($380,000 x 37%). Her basis in the stock is now $20 per share, and she can immediately sell the shares at $20 with no additional taxes.

Scenario 2: If Kate exercises her options today, the spread would be $160,000 (20,000 options x $8 per share spread) and she would immediately pay federal ordinary income taxes of $59,200 ($160,000 x 37%). Her basis in the acquired shares is now $9 per share. If at the end of two years Company Y goes public and she sells the stock at $20, she would have a long-term capital gain of $220,000 ($11 per share gain x 20,000 shares). Assuming a 23.8% combined long-term capital gain tax rate and Medicare surtax rate, her tax liability would be $52,360. When added to the $59,200 tax paid upon exercise, her total tax bill equals $111,560. While Scenario 2 (also known as early exercise) saves Kate $29,040 in taxes ($111,560 vs. $140,600), there are several other factors to consider. First, by exercising early and committing capital, Kate increases her downside risk by holding shares instead of options.

An election under Section 83(b) of the Code may provide significant tax benefits to the holders of stock options and restricted stock awards.

Another significant factor to consider with Scenario 2 is that funds must be available at the time of exercise to pay the strike price and taxes.

Section 83(b) election

An election under Section 83(b) of the Code may provide significant tax benefits to the holders of both stock options and restricted stock awards. Section 83(b) allows a taxpayer to elect to be treated as if they received vested, unrestricted property from their employer, thereby triggering the immediate income tax liability, even if the property is subject to a substantial risk of forfeiture. This means that the employee can elect to be taxed on the receipt of stock immediately, even if the stock options or restricted stock award are not yet vested.

Why would an employee make this election? It can provide a large income tax benefit if the stock is expected to, and actually does appreciate. This tool can be particularly powerful for stock in pre-IPO companies that have low current 409A valuations. Any future appreciation is taxed at capital gains tax rates, and if held for more than one year after the 83(b) election is made, could receive long-term capital gains tax treatment rather than ordinary income tax treatment.

An 83(b) election must be made within 30 days of the transfer of the stock to the employee. The election must be made in writing and filed with the IRS office where the employee regularly files his or her tax returns. The employee must also send a copy of the election to the employer. An 83(b) election is generally irrevocable. In addition, a significant consideration is that if the property is forfeited in the future (because the vesting requirements were not met), the employee may not take a loss for the taxes already paid.

For an award of restricted stock, an 83(b) election is straightforward. The employee makes an election to be treated as if he or she received the stock immediately without the vesting restrictions. As such, the employee would have ordinary income equal to the number of shares times the current fair market value of the stock (the 409A valuation in the case of a pre-IPO company or the average between the high and the low price on the date of the election in the case of a publicly traded company).

For a stock option grant, the ability to make an 83(b) election will depend on whether the stock option grant agreement allows employees to make an early exercise. Certain plans provide employees with the opportunity to exercise options before the options vest. For example, the option plans of several pre-IPO companies permit the company to grant immediately exercisable options so that employees can exercise options while the company stock has a relatively low valuation. Shares acquired upon early exercise are restricted from resale and may be forfeited if the employee leaves the company before the vesting date.

Since the stock is restricted (and subject to forfeiture if the employee leaves the company), the general tax rules provide that the employee does not realize income from the NQSOs (or preference item for AMT purposes on the ISOs) until the restrictions lapse, i.e., vest. However, if the employee makes an 83(b) election within 30 days of exercise, the income tax consequences may be mitigated long term. If, at the time of exercise, the fair market value of the stock is low, and the strike price is close or equal to the fair market value, the spread will be small, thereby minimizing current income tax on NQSOs and minimizing AMT preference on ISOs. As a result of the 83(b) election upon

exercise, the holding period begins, allowing any future price appreciation to be taxed as a long-term capital gain (if held for more than one year) rather than as ordinary income.

It is important to note one item with respect to ISOs that may be exercised early. As stated above, one of the requirements for ISOs is that only $100,000 of stock (based on the strike price) may become exercisable in any calendar year. If an ISO grant allows all of the stock to be exercised early, then only $100,000 of that stock will receive ISO treatment. If the stock were not subject to early exercise, then more of the grant could receive ISO treatment, because it would only be exercisable as it vested over time.

Section 83(i) election

The Tax Cuts and Jobs Act, passed at the end of 2017, includes a new provision giving employees of pre-IPO companies additional flexibility. It is intended to benefit employees who vest restricted stock or exercise vested stock options before it is traded on a public exchange. In the past, employees in this situation have been hamstrung—for example, the restricted stock vests, so the value of the restricted stock is taxable income to the employee, but the stock isn't liquid and the employee doesn't have the cash to pay the tax.

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Section 83(i) mitigates this problem. It provides that an employee may elect to defer the income associated with vested restricted stock or vested exercised stock options that vest or are exercised after 2017. The employee must make the election within 30 days of vesting or exercise, in a manner similar to an 83(b) election.

Only qualified employees may make an 83(i) election. A qualified employee is one who does not meet any of the follow criteria:

- 1% owner of the company in the current or 10 preceding calendar years.
- The current or former CEO or CFO.
- A spouse, child, grandchild or parent of the first two categories.
- One of the four highest paid officers in the current or 10 preceding tax years.

Income is deferred to the earliest tax year of the employee in which the following occurs:

- The stock becomes transferrable (including to the employer).
- The employee is no longer a qualified employee (as defined above).
- The stock becomes readily tradable on an established securities market (i.e., an IPO).
- Five years after vesting of restricted stock or exercise of vested options.
- The employee affirmatively revokes the 83(i) election.

Note that for the publically-traded trigger for taxation of income, there does not appear to be any continuing deferral for the lock-up period that typically prevents an employee from selling shares until six months after the IPO.

An 83(i) election is available only when the company grants stock options or restricted stock to not less than 80% of the employees. For grants made after 2017, the rights and privileges of the restricted stock or options must also be the same for all employees. So a company may not make special grants to a few executives, and still have those shares be eligible for deferral by the employee. An 83(i) election is not available if the employee already made an 83(b) election. And if an 83(i) election is made on ISOs, they will be treated as NQSOs going forward.

Under the new section, employers have an affirmative obligation to notify employees that stock transferred to them is eligible for 83(i) treatment. If the employer fails to do so, they may be subject to fines up to $50,000 per year.

Gifting equity compensation

As previously noted, equity compensation in the form of stock options and restricted stock awards has again become a significant means of wealth creation for our clients. As a result, clients often look at ways to gift this wealth to children and beyond as part of their estate and gift tax planning. Equity compensation can be difficult to gift however, as it often is an unvested right to receive stock or purchase stock in the future. The IRS takes the position that the transfer of an unvested NQSO is not a completed gift for gift tax purposes.[1] Most tax professionals apply the same methodology to restricted stock awards, and advise that unvested shares of restricted stock may not be gifted. The Code specifically prohibits the gift of ISOs.[2] Therefore, only gifts of vested NQSOs may provide the opportunity for shifting wealth to beneficiaries.

Equity compensation can be difficult to gift because it is often an unvested right to receive or purchase stock in the future.

For gift tax purposes, the fair market value of an option on the date of transfer must be taken into account. The IRS has recognized a methodology of valuing options for gift tax purposes that considers a number of factors including the exercise price of the option, term of the option, current trading price of the underlying stock, expected volatility of the underlying stock and risk-free interest rate over the remaining option term.[3] It is possible that under this valuation methodology, an option with even no spread at the time of transfer will have value. The most common option valuation method that is accepted by the IRS is the Black-Scholes model.

When clients consider gifting NQSOs, traditional gift tax rules apply. In 2018, a taxpayer may give up to $15,000 to any individual ($30,000 per couple) under the gift tax annual exclusion. Any gifts in excess of this amount count against the taxpayer's $11.18 million lifetime gift tax exemption ($22.36 million per couple).[4] Clients may consider using some of these exemptions for gifts of NQSOs. Note that under the Tax Cuts and Jobs Act of 2017, the $11.18 million lifetime gift tax exemption is scheduled to revert to $5 million, indexed to inflation from 2010, in 2026.

In addition, NQSOs can be used in conjunction with strategies intended to transfer the appreciation on assets to beneficiaries. Just as with any other gift, a potential drawback would be if the stock declines in value after the gift is made. In this case, gift taxes would have been paid (or gift tax exemption utilized) based on a value that is higher than the current value of the stock.

When transferring NQSOs via gift, the income tax liability does not also transfer to the beneficiary. If an employee gifts NQSOs, the employee will still be liable for the income taxes payable upon subsequent exercise of the NQSOs. This may actually be an advantage since the tax payment reduces the donor's estate without incurring additional gift taxes.

Conclusion

The size of wealth created and tax liabilities generated from equity compensation can sometimes be exceptionally large. Understanding the structure and mechanics of a stock option or restricted stock award is a first important step in making informed decisions on how to manage these assets. Perhaps the most important factor in deciding how to manage equity compensation is the outlook for the stock and level of risk in having a

substantial portion of one's wealth tied to the fortunes of one company. Cash flow requirements, taxes and the overall economic environment are only a few of the many variables that shape the strategy that will ultimately provide the greatest economic reward. Although various assumptions will need to be made, a planning process that considers the personal, investment, and tax aspects of equity compensation is of critical importance.

– *Erin Wilms,* Head of Advanced Planning
– *Brandon P. Smith,* Wealth Strategist

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See important notes and disclosures on the next page.

When gifting NQSOs, the income tax liability does not transfer to the beneficiary; the employee will still be liable for the income taxes upon a subsequent exercise of the NQSOs.

[1] Revenue Ruling 98-2. https://www.irs.gov/pub/irs-drop/rr-98-21.pdf.
[2] 26 USC 422 (b)(5). https://www.law.cornell.edu/uscode/text/26/422.
[3] Revenue Procedure 2003-68. https://www.irs.gov/irb/2003-34_IRB/ar16.html.
[4] Projected pending final IRS guidance.

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