stock options, restricted stock and deferred compensation

Stock options, restricted stock, and other types of deferred compensation continue to be included by many employers as part of the overall benefits offered to executives of both private and public companies. The taxation of these components of compensation are quite complex and, if these benefits are mismanaged by an employee, the tax cost could be substantial.

STOCK OPTION PLANS

In recent years, the number of companies offering stock options to their employees has decreased. However, given the recent stock market performance, there are many employees faced with important decisions of what to do with the stock options that they presently hold. These options may represent a significant portion of an employee's overall compensation. If you hold stock options, it is vital to understand the tax rules related to your options in order to maximize the after-tax cash flow related to these instruments. You need to frequently review your inventory of options which have been granted but not yet exercised, along with stock still held from previously exercised options, to come up with a strategy for exercising your options and selling your stock, while minimizing your tax exposure.

There are two kinds of employee stock options: incentive stock options ("ISOs") and nonqualified stock options ("NQSOs"). The tax rules governing the taxation of the exercise of options and the subsequent sale of shares differ substantially between ISOs and NQSOs. For all employee stock options there are 3 critical dates to remember for tax purposes: (1) the date the options are granted to you, (2) the date they are exercised, and (3) the date the stock acquired via the options are sold. You must carefully plan when to exercise stock options and how long to hold the shares (after they are exercised) before selling them.

INCENTIVE STOCK OPTIONS

ISOs give you the right to buy company stock in the future at a fixed price that is determined at the time the options are granted. The options usually must be exercised within 10 years of receiving them. They cannot be transferred (except on death) and can be exercised only during employment or within 3 months of leaving the company. The exercise price cannot be less than the stock's fair market value at the time of the grant, and thus the stock must appreciate before the ISOs have any value. If they do — and once you've satisfied the applicable holding periods — you can buy shares at a price that is below their fair market value.

The key tax consequences related to the granting and exercising of ISOs include the following:

- There is no tax liability on the date the options are granted.
- There is no regular tax liability when you exercise a previously granted ISO. However, the spread between the exercise price (what is paid for the shares) and the fair market value of the shares at the time of exercise is treated as an addition when computing your AMTI.
- If the stock acquired by exercising the ISOs is owned at least 2 years from the time the options were granted or one year after they were exercised, whichever is later, a profitable sale of the stock will produce long-term capital gain income taxed at a maximum rate of 20%, plus a 3.8% Medicare Contribution Tax on net investment income for taxpayers above the threshold amounts. The gain will generally be the difference between the fair market value of the stock on the date of the sale and your exercise price. This is known as a qualifying disposition. For AMT purposes, the basis in the stock will be the fair market value on the date of exercise (to account for the adjustment mentioned above). Thus, the capital gain will be lower for AMT purposes than for regular tax purposes, although the maximum of a 20% federal tax rate applies to each.
- A disqualifying disposition occurs if you sell the stock within the later of one year after the option is exercised, or within 24 months of the grant date. The gain on this sale will be included as compensation and will be taxed at a federal rate as high as 39.6%. If the price of the stock sold changed from the date of exercise, you may also have a short-term gain component as well. However, there are no Social Security or Medicare taxes due on the compensation derived from disqualifying dispositions of ISOs.

In order to make the best decision of when to exercise your options and sell the underlying shares from both cash flow and tax perspectives, you need to:

- Project both your regular tax and AMT for the current year to determine the number of shares you can exercise without incurring a current-year AMT liability.
- Project multiple future tax scenarios based on different stock prices to assist you in deciding if you should exercise options now, even at the expense of incurring an AMT liability, to gain from potentially greater future tax savings. Also, you should consider the availability of the AMT credit discussed below.
- Determine how much cash you have available to exercise the options and, if necessary, consider a financing option for purchasing the stock. Among these alternatives are a cashless exercise and a stock swap. These techniques will be discussed later in this chapter.

AMT CREDIT

Even if the exercise of your ISOs results in an AMT liability, you will be eligible in future years to receive an AMT credit for AMT paid on these option exercises in future years. Generally, the credit you can use is limited to the annual amount that your regular tax

exceeds your AMT without regard to the credit in each year. Any unused credit can be carried forward until the full amount is used. While it is usually recommended to avoid paying AMT on ISO exercises whenever possible, there may be situations when you may decide to go ahead with the exercise because of favorable market conditions.

Please see the chapter on tax credits for a detailed discussion of the AMT credit.

ISO SCENARIOS

The first decision you have to make is when to exercise your existing options, from right now up to just before they are due to expire. Once you have exercised the options, you then must decide when to sell the shares. However, the tax consequence of selling the shares compared to continuing to hold the shares can be complicated since it depends on several factors. Some are clearly defined, such as the current trading price, the original exercise price, the trading price at the time of the exercise of the option, and the length of time you have held the shares since you exercised the option. But trying to plan for different scenarios when it is impossible to predict the future price of the stock makes it difficult to know the best choice. Here are some alternatives based on your current holdings combined with certain assumptions.

SHOULD YOU EXERCISE EARLY?

Exercising your options early rather than waiting until the expiration date can be advantageous, but you must consider cash flow and potential tax costs. On the plus side, exercising early:

- Starts your holding period so you can be eligible for the federal long-term capital gain rate that much sooner.
- Allows you to manage your AMT liability by giving you the ability to exercise just enough options to reach a break-even point between the AMT and regular tax (thereby avoiding the AMT). This can be done annually to allow you to exercise your options with minimal, or no, AMT cost.

tax tip

9 ISO TAX BENEFITS

Assume the following facts:

1. You are granted incentive stock options to buy 9,000 shares of your company stock for $20 per share on June 3, 2008.
2. On January 10, 2016, you exercise all 9,000 options when the fair market value is $30.
3. You hold the shares until January 12, 2017 and then sell them for $45 per share, and you were in the AMT in all years up to the year of the sale.

Your tax consequences without considering the Medicare Contribution Tax of 3.8% would be as follows:

- There is no tax due when the options are granted.
- There is no regular tax due when you exercise the grant and purchase the shares. However, you will have an AMT preference of $90,000 (9,000 shares at the excess of $30 over your cost of $20). Assuming you are already in the AMT, your additional AMT tax is $25,200 ($90,000 times the AMT rate of 28%).

When you sell the shares:

- You have a federal regular tax liability of $45,000 computed by applying the 20% long-term capital gain rate to the gain of $225,000, computed by subtracting the cost of $180,000 (9,000 shares at $20 per share) from your proceeds of $405,000 (9,000 shares at $45 per share).
- You will be eligible to offset your regular tax from the sale by $25,200 of AMT that you paid when you exercised the option. This is your AMT credit amount, but you can only utilize it to the extent your regular tax exceeds your AMT before the offsetting credit.
- Even if you cannot utilize the AMT credit because you are still in the AMT, your AMT tax on the gain is $27,000. This is 20% of the AMT gain of $135,000 based on proceeds of $405,000 less your AMT tax cost of $270,000 (9,000 shares at $30 per share when you exercised the options and reported a tax preference amount). You pay the lower AMT tax of $27,000 in the year of the sale rather than the regular tax of $45,000, thus saving $18,000 currently and possibly saving an additional $25,200 in the future.
- If you are not able to use all the AMT credit, you can continue to carry the unused credit forward to offset regular tax in a subsequent year.

- May reduce your overall AMT liability if you are able to exercise the ISOs at a time when you think the market price is close to bottoming out. Since the price is lower and the spread between the fair market value and your exercise price may be negligible, you can exercise more options without incurring an AMT liability, or just having to pay a small liability. Even if the exercise triggers the AMT you'll pay less than you would if you had exercised an equal number of options at a time when the stock price was higher.

Alternatively, on the negative side, exercising early:

- Accelerates the use of funds you need to purchase the shares,
- Can create an AMT liability before you have the proceeds from the sale of the stock to pay an AMT liability, and
- Exposes you to a loss if the value of the shares drops below your exercise cost.

ISO EXERCISED IN PRIOR YEARS

Assume the following: You have held 10,000 shares for more than 12 months from the exercise of an ISO grant in a prior year. Your exercise cost was $15 per share, and the stock was trading at $25 per share when you exercised the grant. You were subject to the AMT in the year of the exercise on the full amount of the spread between the fair market value of $25 and the exercise cost of $15.

If the current trading price is lower than your exercise price
If you have net capital gains for the year, you can sell the shares and realize a capital loss. As an example, assume the stock is currently trading at $12 per share. While you would only have a $3 per share regular tax loss ($12 less your exercise cost of $15), your AMT loss would be $13 per share ($12 less the $25 value when you exercised the options). If you are in the AMT this year, your AMT loss on the sale would be $130,000 ($13 per share times 10,000 shares), creating a potential total savings of $27,140 in taxes ($130,000 times the 20% long-term capital gain rate plus $30,000 times 3.8% Medicare Contribution Tax on net investment income).

If the current trading price is higher than your exercise price but lower than the trading price at the time you exercised the grant
Assume the stock is currently trading at $19 per share. If you are not in the AMT for the year, you will realize a gain of $4 per share ($19 less exercise cost of $15), resulting in a tax of $9,520 (23.8% of 10,000 shares at $4 gain per share). But you may actually save taxes since you have an AMT credit available to offset your regular tax, if not already utilized. The AMT credit is $28,000 (28% of 10,000 shares at an AMT spread of $10 per share). Your tax savings will be $18,480 ($28,000 AMT credit less the $9,520 regular and Medicare Contribution Tax on the sale, assuming you have sufficient regular tax liability).

The current trading price is higher than both your exercise price and the trading price at the time of the exercise
If you sell the shares, you will have a capital gain for both regular tax and AMT purposes. Assume the current stock price is $35. If you are not in the AMT, you would pay tax on the gain of $20 per share ($35 less your exercise cost of $15). As discussed above, you may have an AMT credit available to offset the tax on the gain. If you are subject to the AMT this year, your AMT gain would be $10 per share ($35 less the price at the time of exercise of $25). Your tax increase for federal tax purposes would be based on the AMT gain of $10 rather than the regular tax gain of $20. However, the additional 3.8% Medicare Contribution Tax on net investment income would be based on the $20 gain.

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ELIMINATE THE AMT IF THE STOCK PRICE DROPS AFTER AN EXERCISE

A falling stock price can result in costly tax consequences if the sale of stock purchased through exercising an incentive stock option is not planned for properly. Take the facts in Tax Tip 9 but assume your exercise of 9,000 shares was earlier this year and the price per share has fallen back to $20, your exercise price. As Tax Tip 9 demonstrates, your AMT tax on the exercise would be $25,200 ($90,000 preference at 28%) if the AMT applies. You will have to pay this tax even though the selling price of your shares is currently equal to the price you paid for them.

What can you do? Sell the shares before the end of the year so that you will have a disqualifying disposition. You would not have a regular tax liability since the selling price of $20 is now equal to your exercise price. But you will eliminate the $25,200 AMT that you would pay if you did nothing.

It may make sense to consider selling the shares even if the selling price is greater than your exercise price. Let's say the stock price has dropped to $23 per share after exercise and you will be in the AMT this year. If you sell the stock before the end of the year, you will realize ordinary income of $27,000 (9,000 shares at a gain of $3 per share based on the selling price of $23 and your cost of $20 per share). However, the AMT liability on the disqualifying disposition will be $7,560 ($27,000 x AMT rate of 28%), which is less than the $25,200 AMT that you would pay if you held the shares (as computed above). Because the wash sale rule (as discussed in the chapter on capital gains) does not apply to securities sold at a gain (regardless of any AMT benefit you receive), you can then repurchase the shares in the open market, even at a lower price, so that you would still own the same number of shares.

tax tip

11 USE THE AMT TO YOUR ADVANTAGE TO REDUCE TAXES ON THE SALE OF ISOs

Assume you exercised an ISO grant in 2007 and purchased 30,000 shares at the exercise price of $5 per share when the stock was selling for $15 per share. Despite the tax preference amount of $300,000 (30,000 shares times the $10 per share spread) you did not have an AMT liability that year because you had substantial ordinary income. You sell the shares in 2016 for $40 per share and you are in the AMT.

	Regular tax	AMT
Long-term capital gain	$ 1,050,000	$ 750,000
Tax at 20%	**210,000**	**150,000**
Effective tax rate on sale	**20%**	**14.29%**

Please note this table does not include impact of the Medicare Contribution Tax on net investment income.

The long-term capital gain for regular tax purposes is $1,050,000 (proceeds of $1,200,000 less the $150,000 you paid to purchase the shares). For AMT purposes, the gain is only $750,000 since your basis is $15 per share (fair market value at the time of the exercise, even though you did not pay the AMT in that year). The result of the sale is that you only pay a current federal effective tax rate of 14.29% ($150,000 tax on the actual gain of $1,050,000).

ISOs EXERCISED EARLIER IN THE CURRENT YEAR

If you exercised ISOs earlier in the year, you may want to consider selling the shares in a disqualifying disposition if certain conditions exist. Again, let's assume an original exercise price of $15 per share and a trading price of $25 per share at the time of exercise.

If the current trading price is less than the price you paid to exercise the option

First, determine if the AMT preference amount of $10 per share ($25 trading price at the time of exercise less your cost of $15 per share) will put you into the AMT or increase an already existing AMT liability. If so, consider selling the stock to eliminate the AMT that you will have to pay even though the stock price has dropped. As Tax Tip 10 illustrates, you could end up with a substantial tax without any funds to pay the tax. Also, you can always buy back the stock as long as you wait 30 days to avoid the wash sale rule discussed in the chapter on capital gains and dividends. If the AMT preference amount does not put you into the AMT, you can choose to continue holding the shares if you believe the stock will appreciate.

If the current trading price is higher than your exercise price but lower than the trading price when you exercised the option

If you sell the shares, you will have a disqualifying disposition and the excess of the current trading price over your exercise price will be taxable as compensation at ordinary income tax rates as high as 39.6%. But if you expect to be in the AMT this year, the sale of the shares will eliminate the AMT of $10 per share on phantom appreciation that no longer exists. As an example, let's assume the stock price has dropped to $18 per share. If you sell the shares, you will have ordinary income of $3 per share for both regular tax and AMT compared to $10 of income for AMT purposes had you taken no action.

If the current trading price is higher than both your exercise price and the trading price at the time of the exercise

Once again, if you sell the shares you will have a disqualifying disposition and the excess of the fair market value on the exercise date over your exercise price will be taxable as compensation at ordinary income tax rates. The additional increase on the sale at the date of exercise will be taxed as a short-term capital gain. So if the stock is selling for $30 per share, a sale of the shares would result in $15 of income per share sold taxed at potentially 39.6% for regular tax purposes. In addition $5 per share may be subject to the Medicare Contribution Tax of 3.8%. Thus, if you are not subject to the AMT during the year, it would not make sense to sell the stock during the year. If you would have been in the AMT with or without the ISO preference item it may make sense to sell the shares by year-end. This is because you may never get a benefit for the AMT paid.

NONQUALIFIED STOCK OPTIONS

Unlike ISOs, the exercise of NQSOs creates taxable ordinary income in the year of exercise for both regular tax and AMT purposes. The income is equal to the excess of the stock's fair market value on the date of exercise over the exercise price plus any amount that was paid for the option, where applicable. The granting of an NQSO does not result in taxable income unless the value of the option is readily ascertainable, which generally is not the case. The income recognized upon exercise will be taxed as compensation and will be subject to both Social Security and Medicare taxes.

When you sell the stock after exercising, any appreciation/depreciation in the stock's value will be taxed as capital gains/losses. The holding period for the underlying stock starts when you acquire the shares — it does not include the time you held the options. For long-term capital gain treatment, you must hold the shares for more than one year after the exercise date.

Unlike ISOs, NQSOs are sometimes transferable. However the employee (and not the transferee) will generally recognize income for tax purposes upon the exercise of the options.

You are not allowed to receive in-the-money options without triggering substantial penalties under provisions of the Internal Revenue Code restricting this type of deferred compensation (see below).

Tax Tip 12 illustrates the tax consequences of an exercise and sale of shares received from the exercise of an NQSO grant.

FINANCING TECHNIQUES

Unless you have sufficient available cash, it can be problematic to come up with the funds to exercise your stock options. You can borrow money — sometimes from the company itself — but there are other ways to finance your stock acquisition. Two such techniques are a cashless exercise and a stock swap.

A cashless exercise occurs when a broker lends you the cash needed to exercise the options and then, usually on the same day, helps you sell the stock. The broker recoups the funds you borrowed as well as a small amount of interest and you keep the excess funds. Your cost for the transaction is only the small interest charge.

A stock swap occurs when you use previously acquired company stock to pay for the options' exercise cost. Some companies will even grant you more options called "reloads" if you exercise an option with a stock swap. The number of additional options granted will be equal to the number of shares used to pay the exercise price.

RESTRICTED STOCK

The tax treatment of restricted stock differs considerably from stock options. If you receive compensation in the form of stock subject to a substantial risk of forfeiture, you can defer the recognition of income until the stock is no longer subject to that risk or you sell the stock. But you can elect, under Internal Revenue Code

tax tip

12 NQSO TAX CONSEQUENCES

If the 9,000 shares from exercise of the ISOs in Tax Tip 9 were from the exercise of NQSOs, you will recognize $90,000 of taxable compensation from the exercise (9,000 shares at $30 per share fair market value less the $20 exercise cost). When you sell the stock after holding it for more than one year, from the exercise of NQSOs, you will have a long-term capital gain of $135,000 (9,000 shares at $45 less your basis of $30 per share) at a maximum federal tax cost of $27,000 ($135,000 at 20%). Your net cash benefit from the exercise and sale will be:

Proceeds from the sale	$ 405,000
Cost to exercise the shares (9,000 shares at $20 per share)	(180,000)
Tax on exercise of options ($90,000 at 39.6%)	(35.640)
Tax when you sell the shares ($135,000 at 20%)	(27,000)
Net cash benefit	**$ 162,360**

Note: *This example does not take into consideration Social Security and Medicare taxes.*

Section 83(b), to recognize ordinary income when you receive the stock. You must make this election within 30 days after receiving the stock. However, before making the election, make sure your company's deferred compensation plan with respect to compensation received in the form of stock is in compliance with the requirements discussed in the next section.

A Section 83(b) election can be extremely important if the income taxable to you on the grant date is negligible. Why? Because the election allows you to convert future stock appreciation from ordinary income into long-term capital gain income, which is therefore eligible to be taxed at the much lower long-term capital gain tax rate. If you do not make the election, you will pay tax at ordinary income tax rates on the appreciation when the restrictions lift regardless of whether or not you sell the stock and realize any gain on the sale. See Tax Tip 13.

The disadvantage of making a Section 83(b) election is that you pay tax at ordinary income tax rates in the current year. Plus, taxes paid as a result of the election can't be refunded if you eventually forfeit the stock or the stock's value decreases. You will have a capital loss when you sell the stock, but not if you forfeit it.

DEFERRED COMPENSATION PLANS

The tax treatment of compensation received through a deferred compensation plan depends on rules governing the initial election to defer compensation and the ability to take distributions. The initial election to defer compensation must generally be made in the calendar year prior to the year the income is earned.

Distributions can only be made:

- At scheduled times selected at the time of the deferral, based on either specific dates or the age of the participant.
- At the termination of employment or service.
- On the disability or death of the participant.
- To alleviate an unforeseen emergency.
- Following a change in the ownership or effective control of the employer.

Failure to follow these rules will result in:

- Taxation of the compensation 'deferred' at the time it is deferred or credited to the participant, or at the time it vests, whichever is later.
- An additional tax of 20% on top of the ordinary income tax on the amount treated as compensation.
- An interest assessment based on the IRS underpayment rate plus 1% on the tax liability resulting from the recognition of the compensation.

Note: *ISOs are excluded from these provisions because their exercise price must be equal to their value at the time of the grant.*

ADDITIONAL REPORTING REQUIREMENTS

Every corporation that transferred to an employee a share of stock related to that person's exercise of an ISO during the current tax year is required to file Form 3921 with the IRS for each transfer made. Form 3921 includes the following information:

- The date the option was granted,
- The date the employee exercised the option,
- The number of shares of stock transferred to the employee,
- The fair-market value of the stock when the option was exercised, and
- The exercise price of the stock.

The forms are not required for an employee who is a nonresident alien. Employees must receive the Forms 3921 by January 31 following the end of the calendar year of reporting. The Form is also required to be filed with the IRS with the corresponding Form 1096 by February 28 following the calendar year reported (March 31 if filing electronically).

There are similar filing requirements for employee stock purchase plans.

tax tip

13 THE BENEFIT OF A SECTION 83(b) ELECTION FOR RESTRICTED STOCK

You receive 10,000 shares of restricted stock with a fair market value of $3 per share. In anticipation of an initial public offering ("IPO"), a 10 for 1 stock split gives you 100,000 shares. At the time of the IPO, the stock is offered at $6 per share and the risk of forfeiture is removed. You sell the shares 2 years later at $8 per share.

If you make an Internal Revenue Code Section 83(b) election within 30 days after receiving the stock

- You have $30,000 of compensation in the current year (10,000 shares at $3 per share) with a maximum federal tax cost of $11,880 ($30,000 at 39.6%).
- Your basis in the stock is $0.30 per share after the split ($30,000 of realized compensation divided by 100,000 shares).
- Your holding period begins on the day you receive the stock.
- You realize a long-term capital gain of $770,000 (100,000 shares at $8 per share less your basis of $0.30 per share) when you sell the stock, at a maximum federal tax cost of $154,000 ($770,000 at 20%).
- You incur a Medicare Contribution Tax on net investment income of $29,260 ($770,000 at 3.8%).
- You defer the tax you would have to pay when the company goes public to the time when the stock is sold.

If you don't make the election

- You don't have any compensation income this year.
- You have compensation of $600,000 (100,000 shares at the IPO price of $6 per share) when the company goes public (and the substantial risk of forfeiture no longer exists due to a change of control feature) at a maximum federal tax cost of $237,600 ($600,000 at 39.6%).
- You have a long-term capital gain of $200,000 when you sell the stock (100,000 shares at $8 per share less your basis of $6 per share) at a maximum federal tax cost of $47,600 ($200,000 at 23.8%).

Income Tax Comparison	
If you don't make the election	$ 285,200
If you make the election	195,140
Tax savings by making the election	**$ 90,060**