

Employment Related Stock Options

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Call Options. The buyer has the right to purchase specific stock at a predetermined price within an agreed timeframe. The expiration date could be a year in the future but, more typically, the option expires in a matter of weeks.

If the market moves up, as the call buyer hopes and anticipates, the value of the option appreciates. The tax on this appreciation is deferred. If the option is exercised, the cost of the option is added to the cost of the stock and the unrealized gain continues to be deferred until the stock is sold. If the option expires worthless, the investor is entitled to claim the cost of the option as a capital loss. If the option is sold prior to the expiration date, the investor realizes a capital gain or loss.

The holding period is measured from the date of purchase of the option. Gains and losses are short term if the holding period is a year or less and long term otherwise.

Employers use call options to focus employees' attention on the company's stock price. They also use options to aid employee retention. Typically, an employee is granted the right to buy the employer's stock at about the current market price with an expiration date years in the future. Because the employee cannot take advantage of the option until it vests, there is no current tax liability.

While similar to the call options traded on a stock exchange, employer options almost always have special features such as the extended expiration date. This distinction is important since vesting would otherwise trigger the recognition of income equal to the fair market value of the option.

Employer options come in three flavors: incentive stock options (ISOs) and employer stock purchase plans (ESPP) are "qualified," meaning that they are afforded favorable tax treatment. Other options are "non qualified."

Non Qualified Employer Stock Options are governed by the rules in IRS Regulation 1.83-7. They can be granted to employees and to independent contractors. The latter category includes non-employee Board members.

After the options vest and have been exercised, the "spread" (the excess of the fair market value of the stock on the exercise date over the exercise cost) is taxable compensation to the employee. As such, it is supposed to be reported with wages on line 7 of the employee's W-2. The spread is subject to income tax withholding (typically 28% federal plus 6% California) and employment taxes (7.65% maximum).

When the stock is sold, the employee recognizes a capital gain or loss measured from the exercise price plus the compensation recognized on the

employee's tax return in the year of exercise. Gain/loss is short or long term depending on whether the sale occurs within a year of the exercise date.

The exercise of non qualified options can trigger a substantial payment to the employer. For example, if the stock price is \$5 per share on the grant date and \$8 per share on the exercise date, the employer is owed \$6.25 per share.

	<u>NonQualified Options</u>
Taxable Income	\$3 per share
Cash Required	
Exercise cost	\$5 per share
Withholding	34% of the spread or \$1.02
FICA and Medicare	Up to 7.65% of the spread or \$0.23

This means that the employee has to pay \$62,500 in order to exercise ten thousand shares.

A "same day sale" or "cashless exercise" is a popular way to raise the money to pay the exercise costs. In this example, the employee's account would be credited with about \$17,500 following the exercise and sale of ten thousand shares. (The sale never occurs at exactly the price assumed in the employer's calculations. Hence the word "about." Another consequence is that there will usually be a small short term capital gain or loss on a same day sale.)

A downside of a same day sale is that the employee pays more income tax. You are likely to pay 35 - 45% in federal and state taxes whereas would pay about 27% if you delayed the sale for a year. In addition, you lose the opportunity to leverage your investment dollars assuming that your company stock is an outstanding investment opportunity. In the prior example, you paid only \$5 to control an \$8 stock.

Exercising the options in a margin account or selling only part of the stock exercise are alternative ways to pay for the exercise.

An 83(b) Election allows an employee to pay tax on the spread even though the exercise is not be a taxable event because the option is not vested or is subject to other restrictions.

The advantage is that the spread is likely to be smaller as compared to waiting until the option is vested or the restrictions removed, meaning that the withholding and FICA tax will be less. For example, exercising ten thousand options on the grant date in the prior example, when the fair market value is \$5 per share, would cost the employee \$50,000 rather than \$62,500.

The risks are that the employee could forfeit the stock or the stock price could decline. The exercise cost would be a capital loss, meaning a partial recovery, but the tax cannot be recovered.

The lower the exercise price, the lower the risk. This is why 83(b) elections are popular with pre-IPO stock. A low price suggests an untested company, or one

with financial difficulties, and thus a higher risk of loss even if the dollars at risk are smaller.

The 83(b) election requires the employer's cooperation since the employer must be willing to let the employee exercise unvested stock. A common solution is to rewrite the employment contract so that the employee must resell the stock to the company at the exercise price if the employee leaves prematurely.

The election is irrevocable and should not be made without professional advice if the dollar amounts are substantial. The 83(b) election applies to both non qualified and statutory options.

Statutory Options

The primary advantages of statutory options is that more of the gain is afforded long term capital gain treatment and that exercise does not trigger a regular tax liability. The results are that exercising a statutory option costs the employee less than exercising a non qualified option and he or she gets to keep more of the proceeds from the ultimate sale.

A disadvantage is that the stock must generally be held for two years from the grant date and one year of the exercise date. (The primary exceptions are death, transfers incident to divorce or to pay for the exercise of more statutory options.) If the stock is sold or transferred before these holding periods are satisfied, the sale or transfer is taxed according to the rules for non qualified options. A premature sale or transfer is referred to as a "disqualifying disposition."

A statutory option satisfies the holding periods if it is granted June 1st, exercised June 1st of the following year and sold June 1st two years after the date of grant. If you had purchased the stock on June 1st, as opposed to exercising the option, you would have had to hold the stock until June 2nd - an extra day - to achieve favorable long term capital gain treatment.

A same day sale is a disqualifying disposition. If you anticipate needing to sell to pay income taxes, consider exercising in early April since a sale the next April (when the taxes are due) will not be a disqualifying disposition.

Other disadvantages of statutory options are

- Statutory options can only be exercised by the employee or by the employee's estate. This means that you can't gift statutory options or use them to fund a charitable trust or transfer them to an IRA prior to exercise.
- An employee must exercise a statutory option within three months of leaving employment whereas there is no such limit on non qualified options.
- Statutory options are not available to contractors and independent Directors.

- There are limits on how many statutory options can be granted. Certain employee-owners and highly compensated employees are not eligible. An employee cannot be granted more than \$25,000 ESPP options annually and there is a \$100,000 limit on the ISOs that an employee can exercise in any given calendar year. These values are based on the fair market value of the stock on the grant date. If an employee is granted options which exceed these limits, the excess options are treated as non qualified options. For more information and examples, see RIA's "Incentive Stock Options and Nonstatutory Options," October 1999.

ISOs. Exercise does not trigger regular tax and the capital gain or loss on a qualified sale or transfer is long term and is measured from the option price.

If the stock is sold or gifted or transferred prematurely, the difference between the fair market value on the exercise date and the exercise cost, the "spread," is taxed as ordinary income. If the stock price has declined and the sale price does not exceed the exercise cost plus the spread, the ordinary income is limited to the excess of the sales price over cost. If the sale price is less than the exercise cost, there is no ordinary income and a long term capital loss.

The spread on exercising an incentive option is an AMT preference item. Small amounts of preference income are benign but large amounts, especially when coupled with large long term capital gains and state income tax payments, can produce a federal and California AMT liability approaching 35% of the spread.

Some or all of this extra tax could generate a refundable AMT credit and so, with careful planning, AMT means tax acceleration not extra tax. Since AMT is a tricky area; get professional assistance if the dollar amounts are substantial.

Example. An employee pays \$8.50 per share for ISO stock worth \$10. There is \$1.50 per share AMT preference income on the exercise date but no income for regular tax

The stock is sold for \$12 per share. The employee reports \$3.50 per share long term capital gain and \$2.00 per share long term AMT gain in the year of sale.

Alternatively, the stock is sold in a disqualifying disposition and the employee reports \$1.50 per share ordinary income, \$2.00 per share capital gain and \$2.00 AMT gain in the year of sale. The gains are long term if the sale occurs more than a year after exercise and short term otherwise.

If the disqualifying disposition occurs in the year of exercise, there is no AMT preference income and the AMT gain or loss is the same as the capital gain or loss.

Example. The sales price is \$9.00 per share. The employee reports a \$0.50 per share long term capital gain and \$1.00 per share long term AMT loss.

If the stock is sold in a disqualifying disposition in the year after exercise, the employee reports \$0.50 per share ordinary income, no regular gain or loss and a \$1.00 per share AMT capital loss. The loss is long term if the sale occurs more than a year after exercise and short term otherwise.

Example. The sales price is \$8.00 per share. The employee reports no ordinary income, \$0.50 long term capital loss and \$2.00 long term AMT loss, per share.

If the stock is sold in a disqualifying disposition in the year after exercise, the employee reports \$0.50 capital loss and \$2.00 AMT loss, per share. The losses are long term if the sale occurs more than a year after exercise and short term otherwise.

If the stock is transferred in a disqualifying disposition in the year of exercise, AMT is not a factor. A disqualifying disposition is therefore a wise move if the stock value plummets in the year of exercise.

Example: Ten thousand incentive stock options are exercised at 55 cents per share when the fair market value is \$35. This generates \$344,500 of AMT preference income. The stock crashes to 50 cents a share. You have a huge AMT liability, probably something in excess of \$100,000, and worthless stock. A disqualifying disposition in the year of exercise reverses the AMT liability and saves the day.

	<u>Sell in the Year of Exercise</u>	<u>Sell in Subsequent Year</u>
Exercise Cost, per share	\$0.55	\$0.55
"Spread" on the exercise date	Not relevant	\$34.45
Sales price, per share	\$0.50	\$0.50
Taxable income, year of exercise	Not relevant	\$344,500 preference income
Taxable income, year of sale	\$500 short term capital loss	\$500 capital loss \$345,000 AMT loss

If the stock is transferred in a disqualifying disposition the year after exercise, the employee would be in the unfortunate position of having passed up favorable long term gain treatment without escaping the AMT liability in the year of exercise.

The ordinary income realized in a disqualifying disposition is compensation in the sense that the employer is entitled to a payroll deduction. This income is NOT subject to withholding or employment taxes. See IRS Notice 87-49.

There is currently no tax withheld when an ISO is exercised. However, IRS Notice 2001-14 announced that the IRS is studying income tax withholding and FICA and FUTA tax. There will be no changes before January 1, 2003. Until then at least, the employee is on his or her own to make the estimated tax payments necessary to avoid underpayment penalties. It is wise to obtain professional assistance with these calculations if the tax liability is substantial.

The employee has the responsibility to determine fair market value. Sometimes, the company will announce a valuation and, if the company is issuing new options, the newly announced exercise price might serve as an estimate of market value. The IRS has used the Black-Scholes model to price options. When the fair market value is unclear and the tax implication significant, it may be necessary for the employee to obtain a professional valuation.

ESPPs. Exercise does not trigger regular tax. The "discount," which cannot exceed 15% of the fair market value on the date of grant (or the date of exercise in some plans) is taxed as ordinary income on sale or transfer. If the transfer is a sale, any additional gain is long term capital gain.

If the transfer is a gift, the discount is recognized as ordinary income and the donee's basis for figuring gain on loss on an eventual sale is measured from the exercise cost plus the discount.

If the transfer is because of death, the discount is recognized as ordinary income on the decedent's final income tax return and the basis for figuring gain on loss is measured from the exercise cost without considering the discount. See Regulation 1.423-2 for examples and additional detail.

The discount is subject to FICA and other employment taxes but not to income tax withholding; see IRS Publication 15-A. This treatment is analogous to deferred compensation where the income tax is deferred but the employment taxes are due immediately.

Comparison. Market value is \$5 per share on the grant date and \$8 per share on the exercise date. ESPP shares are exercised at \$4.25 per share, a 15% discount, while ISO and NonQuals are exercised at \$5 per share.

	<u>NonQualified Options</u>	<u>ISO</u>	<u>ESPP Options</u>
Taxable Income	\$3 per share	None	None
AMT Income	None	\$3 per share	None
Cash Required			
Exercise cost	\$5 per share	\$5 per share	\$4.25 per share
Withholding	34% of \$3 spread	None	None
FICA, Medicare	Up to 7.65% of \$3 spread	None	Up to 7.65% of 75¢ discount

Qualified Sale

	<u>NonQualified Shares</u>	<u>ISO Shares</u>	<u>ESPP Shares</u>
Sales price is above the fair market value on the date of exercise.	The sales price less the option price less the spread is a capital gain or loss. The gain is short or long term depending on the time from exercise date.	The sales price less the exercise cost is a long term capital gain.	The 75¢ discount is ordinary income. The sales price less the option price less the discount is a long term capital gain.
Sales price is above the exercise price but less than the fair market value on the date of exercise.	Same as above.	Same as above.	If the sales price exceeds the option price plus the discount, the discount is ordinary income and the excess is a long term gain. Otherwise, the sales price less the option price is ordinary income and there is no gain.
Sales price is below the exercise price.	Same as above.	The sales price less the exercise cost is a long term capital loss.	The sales price less the exercise cost is a long term capital loss.
AMT	Not applicable.	Basis is the exercise cost plus the spread.	Not applicable.

Disqualifying Disposition

	<u>ISO Shares</u>	<u>ESPP Shares</u>
Sales price is above the fair market value on the date of exercise.	The spread is ordinary income. The sales price less the exercise cost less the spread is a short or long term capital gain.	The discount is ordinary income. The sales price less the exercise cost less the discount is a short or long term capital gain.
Sales price is above the exercise price but less than the fair market value on the date of exercise.	The sales price less the exercise cost is ordinary income. No capital gain. Reg. 14a.422A-1. Q&A-2.	See above.
Sales price is below the exercise price.	No ordinary income. The sales price less the exercise cost is a short or long term capital loss.	See above.
AMT	Gain or loss is measured from the exercise cost plus the spread. Not applicable if disposition occurs in the year of exercise.	Not applicable.
Withholding, FICA, Medicare	Not applicable.	Not applicable.

Although the amount of ordinary income recognized on a disqualifying disposition of ISO stock is limited by the Internal Revenue Code, there is no analogous limit on the amount of ordinary income recognized on a disqualifying disposition of ESPP stock. Some commentators assume that this is an oversight and apply the ISO limitation to ESPP shares.

California's Rules are the generally the same as federal for employer stock options, other than the fact that California does not have a special tax rate for long term gains and losses. However, employees who earn less than \$40,000 from the corporation issuing a non qualified option may elect to treat the option according to the ISO rules on their California return. This privilege is limited to grants of 1,000 shares or less and the option must be issued in the four year period from 1998 through 2001. See California Revenue and Taxation Code Sections 17502 and 24602 for additional restrictions.

For investment considerations, go to www.lingane.com/tax/options.htm.

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