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Stock-based compensation: Tax forms and implications

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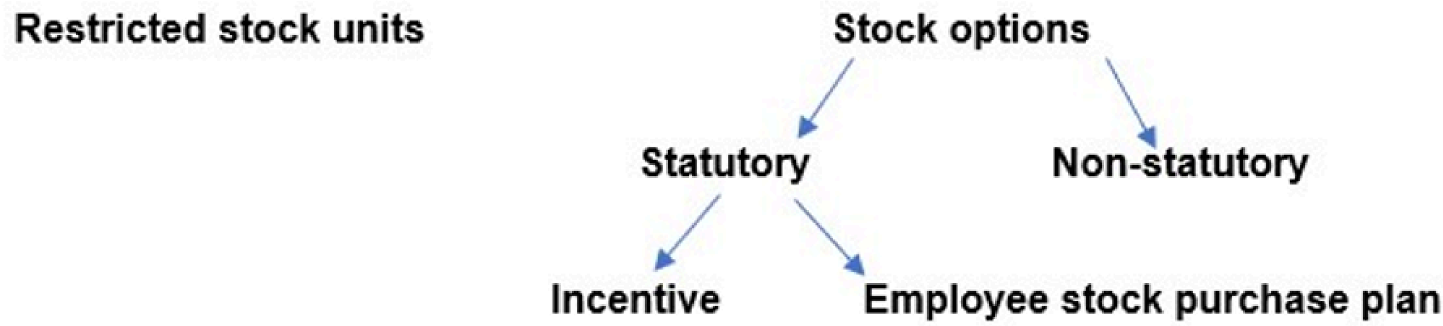
Many companies provide stock (i.e., equity) compensation packages to employees. From an employer's perspective, there are many benefits. First, it helps the company avoid paying higher cash salaries. Second, stock compensation can assist with retention, because employees are more likely to stay at a company to avoid forfeiting stock options. Lastly, providing employees with stock facilitates a sense of ownership, which can improve job performance. The better an employee performs, the more profitable the company; the more profitable the company, the more the stock value increases; the more the stock value increases, the more money for which the employee can sell the stock.

However, while the reasons for providing stock compensation packages are easy to understand, the same cannot be said of the tax implications. This article first describes the various common types of stock compensation, then discusses the relevant federal tax forms and the federal tax treatment. Finally, the focus turns to certain available elections and other noteworthy considerations.

Types of stock compensation



As shown above, there are several common categories of stock compensation. *Restricted stock units* grant the employee actual stock on the day it vests; the employer essentially promises to give the employee stock in the future, which is contingent upon the employee's effort to *earn* the stock. *Stock options*, on the other hand, grant the employee the right to purchase stock at a set price when the option vests. Stock options are the right to *buy*, not earn, the stock and come in several varieties.

Restricted stock units. Restricted stock units (RSU) have become more popular in recent years. The employee typically pays nothing to acquire the stock since it is part of compensation. The company will specify what amount of stock each RSU is worth once it vests (e.g., 20 shares of stock or a one-RSU-to-one-share ratio). While the company has discretion, the standard vesting period for RSUs is three to five years.

Statutory stock options. These come in two types: incentive stock options (ISOs) and options offered through an employee stock purchase plan (ESPP). For either type, an employee is given the option to purchase shares of stock at a future date for a fixed price, called a strike price.

ISOs. ISOs tend to be the most structured stock compensation packages because numerous rules apply to them (Sec. 422). By law, the option to purchase the stock must be non-transferable and expire after 10 years. In addition, the individual must be an employee on the date the stock options are received and must exercise the options while remaining an employee or within three months of leaving the company. Further, among other requirements, the strike price cannot be less than fair value the day the options are granted.

ESPPs. ESPPs let employees purchase stock, typically with a 5% to 15% discount, through a payroll election (Sec. 423). This operates like a 401(k). The employee makes an election, and the employer reduces the employee's net paycheck and purchases stock on the employee's behalf with the amount taken from the paycheck. Unlike a 401(k), however, the employee's income reported on Form W-2, *Wage and Tax Statement*, is not reduced by the amount the employer withholds to purchase the stock.

Typically, employers "collect" funds from an employee for six months before purchasing the stock. This creates a lookback period. During the time the employer withholds funds before purchasing the stock, the stock price could increase or decrease. However, the option price does not change. It is a set price based upon a percentage of the fair value when the option is granted.

To see the effect of the lookback period, assume the option price on the date the option was granted (the grant date) was a 15% discount from the fair value, but the stock's fair value increased six months later. Therefore, when the stock is purchased, the effective discount would be greater than the original 15% since the option price was fixed on the grant date. This creates tax implications upon sale of the stock but not issuance.

Holding period. For both ISOs and ESPPs, holding period rules apply. Specifically, an employee cannot sell the stock until two years after the grant date and at least one year after exercising the option (that is, purchasing the stock).

There can be an overlap between these periods. Under Regs. Secs. 1.422-1(a)(1)(i)(A) and 1.423(a)(1)(a), the *later* of the two events determines the holding period that must be met in order to retain qualified (i.e., statutory) treatment.

> ***Example:*** Assume an individual was granted stock options on Jan. 1, 2020, and there was a six-month vesting period. The individual exercised the options right after the vesting period on July 1, 2020. The requirement to hold the stock for two years from the day the stock options were granted would be satisfied Jan. 2, 2022, and the requirement to hold the stock for one year from the exercise of the options would be satisfied July 2, 2021. Therefore, since the *later* of these two dates is Jan. 2, 2022, this is the applicable date to which the individual must wait to sell the stock.

If the holding period requirements are not met, the statutory stock option becomes disqualified and is treated by default as a non-statutory stock option.

Non-statutory stock options (NSOs). Also known as non-qualified stock options, NSOs are the catch-all of stock options. Essentially, if the stock option fails to qualify as statutory (ISO or ESPP), it is a non-statutory stock option.

The group of individuals qualifying for NSOs is broader than ISOs because independent contractors as well as employees can be awarded NSOs.

As with statutory stock options, the individual is given the option to purchase shares of stock in the future for a specific price. The strike price is typically lower than fair value, resulting in a discount, called the bargain element.

Tax forms and tax treatment

With this background on the main categories of stock compensation, let's look at tax forms and treatment. How do accountants know what type of stock compensation their client has? They can tell based on the manner the stock compensation is reported, such as the tax form number. And how does an accountant know how to handle such a form? The general rules are summarized in the table "Tax Implications of Stock-Based Compensation" and further discussed below.

Tax implications of stock-based compensation

	Restricted stock units	Incentive stock options	Employee stock purchase plan	Non-statutory stock options
Amount employee pays to acquire	Nothing	Strike price	Strike price	Strike price
Amount included in income and when	Vest day — fair value of stock	Exercise day — AMT adjustment (positive) for spread	Sale year — discount/spread	Exercise day — discount/spread
Tax form	Included in W-2 Box 1, 3, and 5 (and optionally Box 14)	Form 3921	Form 3922 and W-2 Box 1 (discount)	Included in W-2 Box 1, 3, and Box 5 and Box 12 Code V
Basis on future sales	Amount included in W-2 income	Strike price for regular tax. FMV at exercise for AMT	Spread (amount included in income) plus strike price	Spread (amount included in income) plus strike price
Employer	Deducts amount included in W-2 employee income	No deduction	Deducts amount included in W-2 employee income	Deducts amount of the spread

Restricted stock units

Tax form. Employers will include in income on the W-2 the fair value of the RSUs as of the day they vest. This fair value will be reflected in Boxes 1, 3 (up to the annual Social Security limit), and 5. Optionally, employers are highly encouraged to indicate in Box 14 the letters "RSU" and the value of the stock included in the W-2 income. If this information is not easily identified in Box 14, the employee will have to inform the accountant that RSUs were included in wages. Why? So that basis can be tracked. The stock's fair value included in income becomes basis for calculating gain when the shares are later sold.

Tax treatment. Since RSUs are included in W-2 income, the employee is taxed at ordinary (as opposed to capital gain) tax rates on the value of the shares. The employer may take a deduction on its tax return for the amount included in the employee's W-2. On future sales, the basis of the stock received will be the amount the taxpayer included in taxable income. The traditional holding period rules apply when the stock is later sold, i.e., stock that was held 365 days or less yields short-term capital gains or losses, generally taxed at ordinary rates, and stock that was held for more than 365 days yields long-term capital gains, taxed at capital gain tax rates.

Statutory stock options

Tax form for ISOs. The tax reporting is different for statutory stock options. For ISOs, nothing is included in regular taxable income in the year the options are granted or exercised, so there is nothing reported on the W-2. However, in the year of exercise, an amount for the alternative minimum tax (AMT) adjustment for the exercise of ISOs (discussed below) will need to be included on Form 6251, *Alternative Minimum Tax — Individuals*. To assist in the AMT calculation, when ISOs are exercised, the exercise price per share, the FMV per share on the date of exercise, and the number of shares transferred are reported to the employee on Form 3921, *Exercise of an Incentive Stock Option Under Section 422(b)*, in the year of exercise.

Tax treatment of ISOs. Nothing is included in regular tax income on the grant or exercise date; therefore, the employer does not take a deduction for providing the employee with ISOs. Regular tax income is only generated when the stock is sold, and the employer receives no deduction.

However, despite there being no regular tax income for the employee when the ISO is granted or exercised, there will be an AMT tax effect in the year of exercise. The difference between the fair value of the stock and the amount the employee paid to exercise the options would be the "discount" (called spread) and is a positive AMT adjustment for the exercise of ISOs in the year the option is exercised, calculated from the information reported to the employee on Form 3921.

If the ISO requirements are met, the holding period rules discussed previously will make the gain or loss from all future sales of the stock received from an ISO exercise taxed at long-term capital gain rates. For regular tax purposes, the basis of the stock sold will be the amount the employee paid to acquire the stock (i.e., the strike price paid to exercise the ISOs). The basis of the stock for AMT purposes from the sale of stock received from the exercise of ISOs is calculated separately. The AMT basis of the stock sold will be the amount the employee paid to acquire the stock plus the amount the employee included as an AMT adjustment for the exercise of ISOs when the ISOs were exercised.

Tax form for ESPPs. For ESPPs, information is reported to the employee in the year the options are exercised on Form 3922, *Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c)*, but there is no income when the options are either granted or exercised. In the year of sale, however, the "discount" given to the employee (calculated based on Form 3922) is taxable income reported on the W-2. The discount amount is the lesser of 1) the stock's FMV less the option price on the date of *grant*, or 2) the stock's FMV less the option price on the date of *sale*. This amount is only Box 1 income and is not subject to Social Security and Medicare taxes. Therefore, if the employer does not report the discount in Box 1, the employee should include it as other income on the 1040 (not subject to self-employment tax).

Tax treatment of ESPPs. Nothing is included in income in the year of grant or exercise. In the year of sale, the spread (or discount), as discussed above, is taxable ordinary income. The employer may take a deduction for the discount included in the employee's income. If the holding periods discussed previously are met, the gain from the sale of the stock in excess of the spread amount that is included in gross income as ordinary income is taxed at long-term capital gains rates.

Non-statutory stock options

Tax form. The tax reporting for NSOs is entirely different. In the year the NSOs are granted or become vested, the employee includes nothing in income. However, in the year the NSOs are exercised, the spread (fair value less strike price) is included as W-2 income to the employee. This spread will be shown as a Box 12 Code V item on the W-2. This spread is *already* included in Boxes 1, 3 (up to the Social Security annual limit), and 5, so the accountant does not need to manually gross up the W-2 wages. Rather, the Box 12 Code V amount reports the NSO income amount separately because it has tax implications beyond being compensation income on Form 1040, including being part of the calculation of the basis of the stock received when the NSOs are exercised, as discussed below.

Tax treatment. In the year of exercise, the W-2 Box 12 Code V spread is ordinary income. Therefore, the employer may take a deduction for this amount.

The amount the employee included in W-2 income (i.e., the spread) plus the strike price paid (the amount the employee paid to exercise the option) is the employee's basis for future sales of the stock received from the NSO exercises. The tax rate on the subsequent sale of the stock by the employee is determined based upon the normal holding period rules (gain or loss on stock held less than one year after the exercise date is taxed at short-term capital gains rates; gain or loss on stock held one year or more, at capital gain rates). The holding period for the stock begins on the day the NSO was exercised (i.e., the date the employee actually buys the stock) not the day the stock was granted.

Caveat: The above treatment is predicated on the assumption that the stock option does not have a readily determined fair market value (i.e., not traded on a stock exchange), which is the most common case with NSOs. For more information, see IRS Publication 525, *Taxable and Nontaxable Income* (rev. Feb. 7, 2023).

ELECTIONS AND OTHER CONSIDERATIONS

Sec. 83(b) election. As discussed previously, income caused by the exercise of most stock options is included in the employee's gross income on the exercise date, which is after the grant date. Where the stock received from exercising an NSO has a vesting period, however, the income is included in the employee's gross income on the vesting date. If the NSOs can be exercised before the vesting date of the underlying stock, a Sec. 83(b) election can be used to shift the inclusion in income from the vesting date to the exercise date, including the fair value of the stock (less any strike price paid) in taxable income earlier than it otherwise would.

If the fair value is expected to increase substantially during the vesting period, it may make sense to pay tax on the fair value at the date of exercise before the stock appreciates. This does result in a lower basis for future stock sales, indicating more gain later. Nevertheless, this gain is taxed at capital rates and, typically, it is better to have more gain taxed at capital rates rather than ordinary income rates.

There are tight timelines to make the 83(b) election, so effective communication with clients before receiving stock or stock options is key to avoid missing this potential tax strategy.

Net unrealized appreciation. While not entirely related to equity compensation, considering this article's discussion of employer stock, the proximity of net unrealized appreciation (NUA) to this discussion should be briefly noted. If an individual has employer stock in their 401(k), it might be beneficial to think about an NUA treatment. The stock in the 401(k) is rolled over to a non-retirement account (a typical brokerage account, trust, etc.). The cost basis of the shares is included in ordinary income (since it had been tax deferred in the 401(k)). The individual could then sell the stock out of the traditional brokerage. The basis of the shares in this sale would be the amount included in income when the shares are distributed from the 401(k).

The gain would be taxed at long-term capital gain rates immediately — no holding period required. This is beneficial because if the stock had been left in the 401(k), each time a withdrawal occurred, it would be taxable as ordinary income, reported on a Form 1099-R. Distributing shares so that they receive NUA treatment thus may shift a portion of the tax paid on employer stock received from the employer from ordinary to capital gain rates. As with the 83(b) election, there are nuances and requirements that require planning and structure in advance of the transaction.

Qualified equity grants. The law known as the Tax Cuts and Jobs Act, P.L. 115-97, made a notable change to taxation of stock options and RSUs. The TCJA created an election that permits qualified employees to defer income taxation for up to five years from the *vesting* date (Sec. 83(i)). The corporation must have a written plan providing stock options or RSUs (not a combination of the two) to at least 80% of U.S. employees and certain other requirements must be met. The election defers the date for recognizing the income but does not change the income's amount or character.

A caveat should be mentioned. As discussed previously, unlike RSUs, most stock options are traditionally included in income upon exercise day. This is important because the five-year period begins on vest day, *regardless* of when the option is exercised. Therefore, by default, since an option is taxable at exercise, which is after vest day, there is an inherent "built in" postponement when compared to RSUs. This built-in postponement will reduce the benefit of the five-year deferral for stock options since their nature is already to be taxed after vest day. Nonetheless, this election may still provide a year or two more tax deferral for stock options (it simply depends upon the length of time between vesting and exercise).

To make the election to postpone tax, an individual will attach a statement (similar to the 83(b) statement) to the tax return for the year of election and provide a copy to his or her employer. The employee will indicate their name, address, TIN, a description of the property, the dates it was transferred, the tax year for the election, the nature of any restrictions, the FMV at the time of transfer, and the amount paid. For additional discussion of the nuances, see IRS Publication 525.

State tax issues. This article's primary focus has been on the federal tax implications. State taxation can vary dramatically. For this reason, practitioners should consult the specific state rules for equity compensation taxation at the state level.

While stock compensation packages can be complicated, their rise in popularity demands tax practitioners develop a working familiarity with the tax implications. This article has provided a brief overview. Further resources to consult include IRS Publication 525; IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits* (rev. Jan. 5, 2023); and IRS instructions for Forms 3922, 3921, and W-2.

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