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**Strategies for Executive**

**Stock Options**

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## Introduction

One of the ways in which companies tie their employee compensation to the performance of the company is by offering forms of equity-based compensation. Equity-based compensation can take several forms. A brief list of the types of compensation strategies are highlighted below and each will be detailed in greater depth at various stages of this course.

The first section of the course is focused on option-based awards and covers the following:

* **Employee Stock Options (ESOs)** – This form of compensation is a compensatory option giving the holder the right to buy the company stock at a fixed price over a set period of time.
* **Performance Options** – This is a form of stock options where the quantity or exercisability is tied to some type of performance criteria.
* **Stock Appreciation Rights (SARs)** – This is a variation of a stock option. The employee receives a grant providing the ability to participate in the upward price movement of the company stock. Unlike an option, the SAR does not require the employee to pay for the stock at exercise.

The second portion of the course covers share-based awards, in particular:

* **Restricted Stock (RS)** and **Restricted Stock Units (RSUs)** – These are outright grants of equity shares or units that equate to shares that have certain time restrictions on their sale and transfer.
* **Performance Shares** – This is similar to restricted stock except the requirement that must be met for them to become saleable or to determine the quantity received is based on a performance criteria rather than time.

Properly structured, equity compensation can both attract and retain employees. It is also an effective compensation strategy commonly used by many organizations in lieu of cash compensation for board members, consultants, and others who are involved in various aspects of an organization’s business.

## Course Objectives

Familiarity with equity compensation has become increasingly important for today’s financial services professionals. Because a great deal of a client’s net worth can be tied up in company stock, financial services professionals must have an understanding of the issues pertaining to each of these types of compensation instruments in order to add value to the client relationship by helping the client explore strategies for their best utilization.

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| **Objectives**  After successfully completing this training module, you will gain an understanding of:   * The structure of different types of equity compensation * The difference between Incentive Stock Options, Nonqualified Stock Options, Stock Appreciation Rights and Performance Options * The difference between Restricted Stock, Restricted Stock Units and Performance Shares * 83(b) Elections * Strategies for managing various types of equity compensation |

## What Makes Equity-Based Compensation So Attractive?

Many people prefer to have a portion of their compensation in some form of equity in the firm for which they are working. This is an attractive alternative for a number of reasons:

* Equity compensation provides an opportunity to participate in the future growth of a company without having to make an investment.
* It is possible to defer the recognition of income and, therefore, taxes to a future date.
  + This is particularly true for incentive stock options, which will be explained in this course.
  + For employees, some stock options can offer the opportunity for the appreciation to be taxed at long-term capital gains tax rates rather than as ordinary income, provided certain requirements are met.
* Stock options provide a form of “leveraged investment,” which can result in rapid appreciation as the stock price appreciates.

## What is a Compensatory Stock Option?

A compensatory stock option is defined below:

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| A compensatory stock option provides the ***right***, but not the obligation, to ***purchase*** company stock at a ***specific price (the “exercise price” or “strike price”)*** over a ***specific period of time***. Because of the specified period of time, the option becomes worthless if not exercised by the end of the specified period of time (the ***expiration*** ***date***). |

Typically, the right to purchase the stock is not immediately available when the compensatory stock option is granted to the employee, but ***vests*** over time. This provides a powerful incentive for the employee to remain with the company and work to enhance the value of the company stock.

If, prior to the expiration date of the option, the option’s exercise price (a.k.a. the “strike price”) is lower than the market price of the stock, then the option holder can receive the difference between the exercise price and the market value of the stock by simply exercising the stock option and then selling the underlying shares. This difference between the exercise price and the market value of the stock is referred to as the ***spread*** or ***intrinsic value***. In this case, when the exercise price is lower than the market value, the spread is positive and the option is said to be “**i*n-the-money***.”

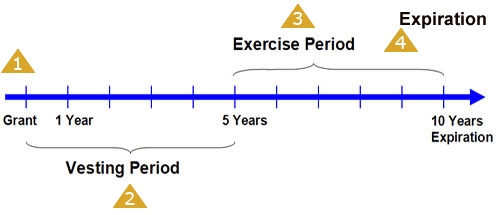
If, however, the market price drops below the exercise price of the option, there is no intrinsic value and it does not make sense to exercise the options since the shares can be purchased in the open market at a lower price. Those options with an exercise price higher than the market values of the stock are said to be “***underwater***” because they have no intrinsic value.

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| **Example.com**  Think of it in these simple terms. In the red-hot "dot.com" industry, many companies were in desperate need of talent, yet short of funding. Many employees were willing to accept compensation packages consisting primarily of compensatory options. As such, if the company went public and share prices soared, they owned the ability to buy the stock at a stated low price, profiting from the difference in that price and the market price. But this was not without risk because the share price in the marketplace could also fall below the options' exercise price, at which point the options would have no intrinsic value. |

## Understanding the Basics of Compensatory Stock Options

There are several key events associated with stock options. Understanding each of these is critical to your understanding of the various types of stock options that your clients may receive. All executive stock options, regardless of the type, have four key elements.

**Click on each of the red numbers to learn more about each event in the life of a compensatory option.**



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| **1 - Grant**  The option holder receives the terms of the option agreement, such as the quantity of options, vesting schedule (or criteria for performance-based options), a "strike" or "option" price, and an expiration date. |

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| **2 - Vesting**  The plan may include a vesting schedule that determines when the option holder has the ability to exercise the options and receive the shares. Think of this event no differently than the vesting of employer contributions to a 401(k) Plan. Vesting schedules vary, as seen in the following examples:   * With “cliff vesting,” at a specific point in time the option holder becomes 100% vested. Example: !00% vesting occurs 3 years after the grant date. * Alternatively, vesting may occur in stages. Example: a plan that vests 25% per year beginning 3 years after the grant date.   Specific events, such as change in control of the issuing organization, may also accelerate vesting. |

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| **3 - Exercise**  Once shares are vested, the option holder may exercise the option to purchase the underlying shares. The exercise of stock options is a voluntary event whereby the individual pays the strike price to acquire the stock and receives the shares. |

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| **4 - Expiration**  All options expire after a specified period. Most options expire in seven to ten years, although it can be longer or shorter. If the option is not exercised prior to expiration, it will become worthless at expiration.  It is important to keep track of this expiration date, as the company is not required to notify an option holder of an upcoming expiration. Millions of dollars of options expire in-the-money. Once an option expires, there is no way to exercise it; the value of the option is lost. Additionally, there are different events that can accelerate expiration, such as termination of employment, retirement, disability, and change in control of the issuing corporation. |

.Two Types of Compensatory Stock Options

For tax purposes, stock options are classified into two types: **Nonqualified Stock Options (NQSOs) and Incentive** **Stock Options (ISOs).** Let’s look briefly at the general definitions of each, followed by a more detailed analysis of the mechanics for both.

**Click each type to learn more**

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| **Nonqualified Stock Options (NQSOs)** |
| Nonqualified Stock Options (NQSOs) are the most common compensatory option granted for purposes of equity compensation. While these options provide the recipient with the ability to participate in future upward price movements in the company’s stock price, they do not have specifically preferential tax treatment like Incentive Stock Options do.  Essentially, any option agreements that do not comply with the Internal Revenue Code for Incentive Stock Options fall into this classification. As such, they are ***not restricted to employees*** and may be used for directors and outside providers. |
| **Incentive Stock Options (ISOs)** |
| Incentive Stock Options (ISOs) ***can only be granted to employees*** and must comply with specific guidelines established by the Internal Revenue Code (IRC) Section 422, which gives them preferential tax treatment. |

## Nonqualified Stock Options

**Nonqualified Stock Options (NQSOs)** have no preferential tax treatment. To better understand them, let’s examine three points in time: the grant of the option, exercise of the option to purchase the shares, and the ultimate sale of the shares. **Click each number to learn more.**

**5 Years**

**Grant**

**1 Year**

**10 Years**

**Exercise**

**Sale**

**1**

**2**

**3**

|  |
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| **1 - Grant**  Typically, the option price when a NQSO is granted is the same as the stock’s current market value, so there is no tax impact when granted. (However, if the strike price is less than the stock’s value when granted, giving the option intrinsic value, then the spread between the market value and the strike price of all shares granted would be taxed as compensation to the employee and deductible by the employer.) |

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| **2 - Exercise**  Upon **exercise, the spread between the strike price and the stock’s current market value, also known as the “Bargain Element” in the option, is treated as *ordinary compensation* *income***, with no regard to whether or not the stock is immediately sold or retained. Upon exercise of NQSOs, employees will be subject to all normal withholding taxes (federal and state income tax, Social Security, Medicare). |

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| **3 - Sale**  Once the exercise of the NQSOs has taken place, the capital gains clock begins. Upon the ultimate sale of the stock, the gains (or losses) will be taxed under the same rules as with any other security. If held for more than a year from exercise, the gains/losses are treated as long-term capital gains or losses. If the stock is sold in less than a year from exercise, the gains/losses are treated as short-term capital gains or losses. |

## Nonqualified Stock Options - Example

Here is an example of a Nonqualified Stock Option. Examine the chart to ensure you understand the details of taxation on NQSO at grant, upon exercise, and at the ultimate sale of the underlying stock.

**Click on each** orange_triangle **in sequence to see the implications at each stage.**

**Stock Price**

**$10**

**$30**

**$50**

**Time**

**Long Term Capital Gain**

**Tax Basis**

**Taxable Compensation**

**Strike**

**Price**

**$10 Exercise**

**Price**

**Sale**

**3**

**21**

**Exercise**

**Grant**

**1**

|  |
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| **1 - Grant (option strike price of $10)**  In this example, the employee receives a stock option grant with a strike price of $10 per share; the current market price when the grant is given is $10 per share. As already discussed, there are no tax implications upon the grant of the option since the strike price is equal to the market value when granted. |

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| **2 - Exercise (stock price at $30)**  As shown in the bar chart, the employee exercises the option while the current stock price is $30 per share. The difference between the grant price of $10 per share and the FMV of $30 on the exercise date (the spread or bargain element) is taxable compensation to the employee. The employee's tax basis is now $30 per share. |

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| **3 – Stock Sale (stock price at $50)**  Assume the employee then holds the stock for 18 months before selling it at the current market price of $50. Since the stock was held for more than a year after exercise, the gains above $30 are taxed as long-term capital gains. Keep in mind the tax basis on the shares after exercise is $30 because tax has already been paid on the bargain element and will not be taxed again. |

## Understanding Incentive Stock Options

Let’s now take a closer look at **Incentive Stock Options (ISOs)**. Examine the following graphic and click on each key event in the life of an ISO to learn more about the implications involving an ISO at each stage.

**Click on each of the number to learn more.**

**5 Years**

**Grant**

**1 Year**

**10 Years**

**Exercise**

**Sale**

**1**

**2**

**3**

|  |
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| **1 - Grant**  ISOs have no tax impact upon the grant to the employee; nor is there a tax impact with vesting. It is important to note that under the IRS Code, these options can ***only be granted to employees.*** |



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| **2 - Exercise**  The option can generally be exercised any time after vesting. It is a requirement that all ISOs must be fully exercised within 10 years of the grant date or three months after the employment has been terminated (one year after if disabled or deceased); otherwise, the option will be lost, or in some cases, convert to NQSOs. When exercised, the shares are purchased at the option price. The employee owns the shares outright at that time, with a basis equal to the option price paid for the securities.  For purposes of regular income taxation, there is no regular income tax consequence when exercising the incentive stock option, as long as the stock is not sold at the time of exercise. This is the primary tax benefit of ISOs over NQSOs. However, the excess of the fair market value of the stock over the amount paid for the stock is a ***tax preference item*** to be used in calculating the alternative minimum tax (AMT), which may trigger increased taxes for the year in which exercise occurs. We will discuss the AMT in more detail in the following pages. |

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| **3 - Expiration**  Once an ISO has been exercised, the employee owns the stock outright. For income tax purposes, there are two possible results that can occur at the sale of the stock.  **According to IRC Section 422, if the ISO stock is sold in less than one year plus one day from exercise OR within two years of the grant date, this is considered a “disqualifying disposition” and the key tax advantages of an ISO are lost and all appreciation above the exercise price will typically be treated as ordinary compensation income.** If sold beyond these dates, then the tax advantages of the ISO are retained and all appreciation above the exercise price will be treated as a long-term capital gain. We will discuss both of these possible scenarios further on the following pages. |

## Understanding “Disqualifying Distributions”

The primary benefit of an employee being granted ISOs is the preferential tax treatment at the time of exercise when the difference between the option price and the FMV of the shares when exercised is not a taxable event except for AMT implications. An additional benefit of an ISO is that when the stock is subsequently sold, the spread between the option price and the FMV of the shares when exercised can be treated as a long-term capital gain. However, these two advantages are subject to the rules governing the sale of the ISO stock after the option is exercised. To receive these benefits, IRS regulations require the optionee (employee) to hold the ISO stock long enough to meet both of the following requirements.

1. The option or the exercised stock must be held for a minimum of 2 years from the grant of the option.

**AND**

1. The stock (once received from exercise) must be held for at least one year from the date following the day of exercise\*.

If the employee sells the stock too soon after the exercise date or grant date, it is considered a "**disqualifying disposition**" and the difference between the strike price and the FMV of the shares when exercised will no longer qualify as a long-term capital gain and will, in most cases, be treated as taxable compensation to the employee. Note that these requirements are waived upon the employee's death.

*\*The holding period for long-term capital gains begins on the day following the exercise of the stock, resulting in a holding period requirement of one year and a day.*

## Tax Impact of a Disqualifying Distribution

When there is a Disqualifying Distribution, the tax treatment to the employee will change depending on the strike price, the stock’s market price at exercise, and the stock’s market price at sale.

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| **Sale Scenario** | **Tax Implications** | **Example** |
| Stock price at which the disqualified shares are sold is below the strike price (not a likely scenario, but possible) | Short-term capital loss | Shares were obtained at a strike price of $20 per share and sold 6 months later for $15 per share.  As a disqualifying distribution, this results in a $5 short-term capital loss per share. |
| Stock price at which the disqualified shares are sold is greater than the strike price but less than or equal to the value at exercise | Compensation income | Shares were obtained at a strike price of $20 per share. At the time of exercise, the market price of the shares was $40 per share; subsequently, when the shares were sold 6 months later, the market price had declined to $30 per share, which was still $10 per share higher than the exercise price.  As a disqualifying distribution, this $10 per share over and above the strike price is treated as ordinary income. |
| Stock price at which the disqualified shares are sold is greater than the strike price AND greater than the value at exercise. | This situation is treated the same as a NQSO, in that:   * The difference between the strike and the value at exercise is taxed as compensation income   AND   * The difference between the market value at exercise and the sale price is a capital gain. | Shares were obtained at a strike price of $20 per share at a time when the market price was $40 per share. Subsequently, when the shares were sold 6 months later, the price had increased to $50 per share.  As a disqualifying distribution, the spread between the $20 strike price and the $40 value upon exercise is treated as ordinary income and the spread from $40 to the sales price of $50 is treated as a capital gain. |

## More Important Rules Pertaining to ISOs

In order to receive the preferential tax treatment, Incentive Stock Options must meet very specific guidelines and rules set forth by the IRS. Some of the most important guidelines the option must meet include the following.

**Click each guideline to learn more.**

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| **Granted to Employees Only** |
| Grants can only be made to employees and must be pursuant to a formal stock option plan. |
| **Option Expiration** |
| Generally, grants must expire (or convert to NQSOs) within three months of termination of employment, within one year of death or disability, or within 10 years of the grant date, whichever occurs first. Note that the company stock option plan can dictate shorter terms than above but cannot allow longer terms.  **Important note regarding “affiliates:”** In the case of employees who have more than 10% of the total combined voting power of all classes of stock in the company (“affiliates” of the company), the timeframe for option expiration is reduced to a maximum of five years and the strike price must be at least 110% of the FMV at grant. |
| **Minimum Strike Price at Option Grant** |
| Options must be granted at the stock's current fair market value or higher. There can be no intrinsic value in the award at the time of grant. In addition to complying with the other requirements for ISOs, this prevents the grant from being considered a taxable event. |
| **Option Transfer** |
| The option cannot be transferable, except at the option holder’s death. |
| **Maximum Annual Vesting Amount** |
| Only $100,000 worth of ISOs, based on the FMV at grant, can become exercisable in any calendar year. *Note that how many options are actually exercised will not affect this rule. This is solely based on when they become exercisable, which is determined by the plan or the grant document.* This rule uses a FIFO accounting method in determining which shares qualify, meaning if the $100,000 limit is exceeded, then the most recently granted options will be disqualified first. In most cases, the record keeper will calculate this, but it is important to keep in mind that an acceleration of vesting can result in the disqualification of much of the ISO.  For example, if there is a change of control in the company (acquisition), the vesting schedule typically accelerates. In that case, 100% of the unvested options will vest on the date a change of control takes place. In such an event, the likelihood of exceeding the $100,000 limit increases significantly, and the most recently granted options are likely to become disqualified. |

## Example of an ISO Grant, Exercise, and Stock Sale

**In the following scenario, click on each** orange_triangle **for each event in the sequence for a graphical representation of what occurs with the ISOs**

**Stock Price**

**$5**

**$15**

**$20**

**Time**

**Long Term Capital Gain**

**Income for AMT Purposes**

**$10**

**Income for AMT Purposes Only**

**$5 Exercise**

**Price**

**Tax Basis**

**21**

**3**

**Exercise**

**Sale**

**Grant**

**1**

|  |
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| **1 - Grant**  Mike Carroll went to work for an e-commerce company on January 1, 2013. As part of his employment, he received 10,000 incentive stock options, exercisable at $5 per share (the FMV of the stock at the time of the grant). |

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| **2 - Exercise**  On January 1, 2015, with the stock selling at $15, he exercised all 10,000 options and held the stock. The cost of the transaction was $50,000, which becomes his cost basis. No ordinary income tax was triggered by the exercise, although it is possible that the inclusion of the excess of the fair market value over the amount he paid for the stock (i.e., $100,000) could result in an AMT tax on his 2015 income tax return. |

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| **3 - Sales**  On January 2, 2016, Mike sold his 10,000 shares at $20 per share, for a realized gain of $15 per share. This $15 per share is treated as a long-term capital gain since he had held them for over a year after the exercise. |

## ISO and NQSO Taxation Summary

Having examined ISOs and NQSOs, let's quickly review the difference in the taxation of the two.

**Click each taxation option to learn more**

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| **Taxation of Nonqualified Stock Options** |
| * Upon exercise, the spread of the fair market value over the exercise price is treated as taxable compensation. * The basis of the stock becomes the fair market value of the stock when the ordinary compensation income tax is paid (either at exercise or upon expiration of restrictions). * After recognition of income at time of exercise or lapse of restrictions, subsequent changes in fair market value are treated as capital gains or losses when the stock is eventually sold. |
| **Taxation of Incentive Stock Options** |
| * No regular income taxes due at exercise of the option. * Basis of the stock becomes the price at which it was exercised. * The spread on the stock's value at exercise is a tax preference item for purposes of the AMT calculation, which may result in an additional tax if the AMT exceeds the regular income tax calculation. If there is AMT tax attributable to an ISO exercise, the AMT paid can be treated as a credit in future years to the extent that regular income tax exceeds the AMT in any given year. * Provided the stock is held for the appropriate period of time, the incremental gains over the strike price receive long-term capital gains treatment. Otherwise, a sale results in compensation income. |

## Understanding the Implications of the Alternative Minimum Tax (AMT)

While ISOs can provide significant income tax benefits to employees, there are some critical issues to consider – particularly the Alternative Minimum Tax (AMT). AMT is a complex tax system that runs parallel to the regular tax system. It was created in the 1970’s to ensure that the wealthy, some of whom used substantial income tax deductions, still paid taxes. Note that the AMT system was not originally indexed for inflation and it was implemented when the regular income tax rates were considerably higher. These two factors have resulted in an increasing number of taxpayers paying the AMT each year.

Understanding the basics of the AMT

The Individual Income Tax is calculated two ways: first, under the regular income tax system, and then under the Alternative Minimum Tax system. There are two primary differences between the two systems.

* **Difference #1**: With regular income tax calculations, each individual has the ability to utilize numerous adjustments and deductions that reduce the taxable income, e.g., deductions for charitable gifts, home mortgage interest paid, etc. With the AMT calculation, many of these adjustments and deductions are added back to regular taxable income. Therefore, if there were sizeable adjustments and/or deductions in the calculation of the regular income tax, the denial of those adjustments in the AMT calculation may generate a higher tax.
* **Difference #2**: The second difference is potentially more significant when a taxpayer exercises an Incentive Stock Option. As previously stated, thre are no regular income tax consequences upon the exercise of ISOs even though economic value was realized by the taxpayer. However, under the AMT tax calculation, when certain items of economic value are derived, like ISO exercise, they are termed “tax preference items” and are includable in income for the AMT calculation. For many people with ISOs, the exercise of those options in any given year could cause the client to slip into a position where they have AMT liability.

## How is AMT Calculated for Non-Corporate Taxpayers?

This is an abbreviated summary and not intended to be a definitive explanation.

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| **Step 1:** Start with the Adjusted Gross Income (AGI) after the Standard or Itemized Deductions have been subtracted from AGI (IRS Form 1040, line 41 - this is before personal exemptions, which are not allowed in the AMT calculation). |
| **Step 2:** Add back (or maybe subtract) certain "adjustments" or "tax preference items.” See IRS Form 6251 and instructions for details. Examples of the *more common* adjustments and tax preference items are listed below:  ADD – Standard deduction if taxpayer does not itemize deductions  ***If Taxpayer uses Itemized Deductions:***  ADD – Medical and Dental itemized deductions that exceed 7½% of AGI and are less than 10% of AGI.  ADD – State, local, property, sales tax deductions  ADD – Interest on mortgage borrowings NOT used to buy, build, or improve your primary residence  ADD – Certain investment interest deductions  ADD – Certain miscellaneous itemized deductions  ***Other common adjustments/tax preference items:***  ADD – With Incentive Stock Options, the excess of the fair market value of the stock over the amount paid for the stock when the option is exercised is usually treated as a tax preference item  ADD – Interest from certain private activity bonds that are exempt from the regular tax  ADD – For most types of property placed in service before 1987, the excess of accelerated depreciation over straight-line depreciation  ADD – Certain adjustments to passive activity losses  ADD – Certain Intangible Drilling costs and Depletion allowances  SUBTRACT – State or local income tax refunds  The completion of Step 1 and Step 2 becomes the "tax base" for calculation of the AMT. |
| **Step 3:** Next, the amount of the basic exemption is calculated and subtracted from the AMT tax base. In 2016, the basic exemption for the AMT is $83,800 for joint returns (MFJ) and $53,900 for single returns. The exemption amounts, however, are phased out over certain income ranges (e.g., in excess of $159,700 in 2016 for MFJ taxpayers). |
| **Step 4:** A two-tiered tax rate structure of 26% and 28% is then assessed against the remaining AMT tax base to determine AMT tax liability. Note that these rates are less than the maximum regular tax rate of 39.6%. However, as you can see from some of the AMT adjustments and addition of tax preference items, the AMT Tax Base can be substantially higher than regular taxable income |
| **Step 5:** Certain foreign tax credits and certain other credits may be allowed that may reduce the taxpayer's AMT.  In determining if there is an actual AMT liability, the total tax calculated by the regular income tax and the AMT are compared. If the regular income tax is greater, that amount is paid and there is no alternative minimum tax due. If the alternative minimum tax amount is greater, the regular income tax is paid and then the difference between the minimum tax and the regular income tax is *added* as alternative minimum tax. |

## AMT Calculation Example

Suppose an individual’s regular income tax in a given year is $50,000 and the Alternative Minimum Tax calculation is $45,500. No AMT tax would be due.

Now, suppose that same individual had exercised $100,000 worth of ISOs, paying $27,000 to exercise. This will not change the ordinary tax calculation; however, the AMT income will increase by $73,000 because the difference between the strike and the exercise of the option is a “preference item” in the AMT calculations and is added in as income for purposes of AMT.

If the AMT was $45,500 without the exercise of the ISOs, and if the additional $73,000 of AMT income is taxed at 28%, the AMT is increased to $65,940 (assuming all other calculations remained the same). In this situation, the individual will have a pre-credit AMT of $65,940. If there is no AMT credit available, the AMT will be $65,940. Since this is higher than the regular income tax, the individual will owe a regular income tax of $50,000 plus an AMT of $15,940.

## The AMT Credit

First, the good news. Generally when all or a portion of Alternative Minimum Tax that is attributable to deferred tax benefits paid, as with the exercise of Incentive Stock Options and Depreciation, an AMT credit is received for future use.

Now, the bad news. This credit is notoriously difficult to use and, even when one can use it, it usually takes years to redeem. The problem lies in the fact that the AMT credit does not work like most tax credits where it will offset the tax dollar-for-dollar. An AMT credit can only be used to offset the regular income tax when there is no AMT owed and only up to the point at which AMT would be due. Stated differently, the AMT credit can only be used against the regular income tax to the degree that AMT is less than the regular income tax.

***Example***. Returning to our earlier example, assume $15,940 was paid in AMT and, therefore, a $15,940 AMT credit would be recorded for possible future use. Let’s suppose that next year, the individual again has $45,000 in taxes under the AMT calculation and $50,000 under the regular tax calculation. Without the credit, the individual would simply pay the $50,000 of regular income tax (since it is higher than the AMT). But since the individual does have an AMT credit, the individual can apply the credit against the regular income tax to the degree that the AMT is less than the regular income tax (e.g., $50,000 – $45,000 = $5,000 of credit that can be applied). Thus, the regular tax will be reduced from $50,000 to $45,000 and the individual, having used $5,000 of the credit, would have a remaining credit of $10,940 to carry forward. As you can see, if the individual’s tax situation remained the same, it would take approximately 4 years to fully redeem the credit.

AMT Relief

As more people in the middle class end up in AMT each year, Congress is under pressure to fix the tax. In recent years, Congress has “patched” the AMT by increasing the flat deduction amount which, therefore, reduces the number of people who must pay the tax. As part of the American Taxpayer Relief Act of 2012 (ATRA), the AMT is now permanently adjusted for inflation.

## Avoiding AMT Associated with Incentive Stock Options

One of the difficult decisions regarding ISOs is determining when to exercise the options. An argument for exercising early is that the holding period for capital gains purposes starts running. An argument against exercising early, at least before there has been considerable appreciation above the exercise price, is that you own the stock once exercised and are subject to capital losses. Nevertheless, one factor that should be considered each year is how many shares can be exercised without generating the AMT. Because AMT can generate a tax bill in the year of exercise, it is wise to give consideration each year to taking advantage of the number of shares that can be exercised before generating AMT.

To identify the number of options to exercise, the option holder can work with his or her tax advisor as year-end approaches to estimate the ordinary income tax on IRS Form 1040 and the AMT on IRS Form 6251.

Example. For purposes of illustration, suppose the regular tax estimate comes to $50,000 and the AMT calculation comes to $40,000. This gives a tax difference of $10,000.

Whenever the AMT is less than the regular tax, this presents a window of opportunity for exercising options without generating AMT. As shares are exercised, the spread on the stock is added to the AMT calculation and are taxed at 26% or 28% (or some of both), depending upon the level of the AMT Tax Base less any exemption. Once the appropriate tax rate of 26% or 28% is identified, it becomes possible to estimate how many shares can be exercised before the AMT increases beyond the regular tax calculation. Note that because the standard deduction under the AMT is phased out for certain income levels, this is nothing more than a rough estimate of the actual tax that might be due. The client’s tax advisor should provide a detailed calculation.

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| To illustrate, suppose the stock options in question make it possible to purchase 10,000 shares at $10 per share, with a current market value of $20 per share, giving a spread upon exercise for AMT purposes of $10 per share. If the AMT estimate is $10,000 below the regular income tax calculation, we can estimate the number of shares that can be exercised without generating AMT as follows:   |  |  | | --- | --- | | 1. Amount by which Regular Tax exceeds AMT | $10,000 | | 2. Divide line 1 by AMT rate of 26% for Alternative Minimum Taxable Income after exemption under $185,400 for 2015 ($92,700 if married and filing separately), otherwise use 28% [Illustration uses 28%]. | $35,714 | | 3. Spread per share upon exercise. | $10 | | 4. Divide line 2 by line 3 = estimated number of shares that can be exercised without generating AMT | 3,571 |   *Note: These calculations are purely to illustrate the principles involved. In actual practice, clients should work closely with their tax advisors to estimate the number of shares that can be exercised without generating AMT.* |

Note that many clients have income from capital gains, qualified dividends, incentive stock options, and interest from tax-exempt private activity bonds that may actually trigger an alternative minimum tax liability. Thus, the financial professional and client cannot necessarily assume that a capital gain or qualified dividends will be taxed at 15%. Especially with affluent and high net worth clients, be careful about making assumptions regarding their actual income tax bracket (federal plus state) when the actual marginal tax rate affects an investment's rate of return.

**Tax planning relative to the Alternative Minimum Tax is very complex. We strongly recommend that any planning involving AMT include the participation of highly-qualified tax counsel. Today, this will potentially involve most affluent and almost all high net worth clients. Be especially attentive to clients that own municipal bond portfolios, receive qualified dividends, have capital gains or capital transactions, or Incentive Stock Options.**











## 



## ISO and NQSO Taxation Summary

Having examined ISOs and NQSOs, let's quickly review the difference in the taxation of the two.

**Click each taxation option to learn more**

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| **Taxation of Nonqualified Stock Options** |
| * Upon exercise, the spread of the fair market value over the exercise price is treated as taxable compensation. * The basis of the stock becomes the fair market value of the stock when the ordinary compensation income tax is paid (either at exercise or upon expiration of restrictions). * After recognition of income at time of exercise or lapse of restrictions, subsequent changes in fair market value are treated as capital gains or losses when the stock is eventually sold. |
| **Taxation of Incentive Stock Options** |
| * No regular income taxes due at exercise of the option. * Basis of the stock becomes the price at which it was exercised. * The spread on the stock's value at exercise is a tax preference item for purposes of the AMT calculation, which may result in an additional tax if the AMT exceeds the regular income tax calculation. If there is AMT tax attributable to an ISO exercise, the AMT paid can be treated as a credit in future years to the extent that regular income tax exceeds the AMT in any given year. * Provided the stock is held for the appropriate period of time, the incremental gains over the strike price receive long-term capital gains treatment. Otherwise, a sale results in compensation income. |

## Review Exercise

**Choose the type of compensatory stock option that best corresponds to each of the following scenarios by clicking your answer:**

1. Upon Exercising the option, the employee must pay the strike price for the stock and is subject to regular income taxes on the spread of the fair market value over the exercise price.

* Incentive Options

**Incorrect. ISOs are not subject to regular income taxes upon exercise, but may be subject to AMT.** Upon Exercising a **Nonqualified** Option, the employee must pay the strike price of the stock and is subject to regular income taxes on the spread of the fair market value over the exercise price. This spread is treated as ordinary compensation income.

* **Nonqualified Options**

**Correct**. Upon Exercising a **Nonqualified** Option, the employee must pay the strike price of the stock and is subject to regular income taxes on the spread of the fair market value over the exercise price. This spread is treated as compensation income.

1. As long as the stock is held for the appropriate period of time after the option is exercised, the incremental gains over the strike price are tax-advantaged and receive long-term capital gains treatment.

* **Incentive Options**

**Corect**. Stocks that are acquired through an **Incentive** Option and held for the appropriate period of time are tax-advantaged and receive capital gains treatment for the spread above the strike price. **For NQSOs, the spread above the strike price at the time of exercise is treated as compensation income. Only the spread thereafter receives long-term capital gain treatment if held for over a year after exercise.**

* Nonqualified Options

**Incorrect. For NQSOs, the spread above the strike price at the time of exercise is treated as compensation income. Only the spread thereafter receives long-term capital gain treatment if held for over a year after exercise.**

1. No regular income taxes are due at the exercise of the option, although there may be AMT implications.

* **Incentive Options**

**Correct. *Incentive*** Stock Options do not generate regular income taxes upon the exercise of the option, although they are taken into consideration when calculating AMT.

* Nonqualified Options

**Incorrect.** Upon Exercising a **Nonqualified** Option, the employee must pay the strike price of the stock and is subject to regular income taxes on the spread of the fair market value over the exercise price. This spread is treated as compensation income. Incentive Stock Options, on the other hand, do not generate regular income taxes upon the exercise of the option, although they are taken into consideration when calculating AMT.

1. The strike price is the basis of the stock when the stock option is exercised.

* **Incentive Options**

**Correct.** The tax basis of stock acquired through an IncentiveStock Option is the strike price at which it was exercised.

* Nonqualified Options

**Incorrect.** Assuming no restrictions, the tax basis of a Nonqualified Stock Option is the FMV of the stock upon exercise. Alternatively, the tax basis of stock acquired through an IncentiveStock Option is the strike price at which it was exercised.

1. Assuming the stock is in no way restricted, the basis of the stock becomes the fair market value of the stock at the time the option is exercised.

* Incentive Options

**Incorrect.** The tax basis of stock acquired through an Incentive Stock Option is the strike price at which it was exercised. Assuming no restrictions, the basis of stock acquired through a NonqualifiedStock Option is the fair market value of the stock when the option is exercised.

* **Nonqualified Options**

**Correct.** Assuming no restrictions, the basis of stock acquired through aNonqualifiedStock Option is the fair market value of the stock when the option is exercised.



## Exercise Methods of Compensatory Stock Options

Once vested, the holder of Compensatory Stock Options has a number of choices regarding strategies to utilize the options.

**Click on each strategy to learn more.**

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| **Cash Exercise** |
| In this case, all that is necessary is to pay for the stock at the exercise price. No ordinary income taxes are incurred upon exercise, but the spread is used for AMT calculation purposes. |
| **Cashless Exercise** |
| Most companies make arrangements with a brokerage company for employees to exercise their options without requiring a cash payment. In these cases, a loan is made for the purchase of the shares (and payment of any tax liability, if desired) and then some of the shares are immediately sold to pay off the loan. The remaining shares are then received without any cash outlay from the optionee.  **Note Regarding ISOs**: This is a disqualifying distribution for ISOs, resulting in the forfeiture of its tax preference treatment and generating compensation income on the sold shares. |
| **Loan** |
| Here, a loan is obtained to provide liquidity for purchasing the stock. If the stock has appreciated significantly, the loan can often be accomplished by purchasing the stock on margin, with the equity in the stock (excess of fair market value over the exercise price) sufficient to cover the equity requirements of the margin account. If the stock pays dividends, the dividend income will help offset the cost of the loan. As a result of the Sarbanes-Oxley Act, however, companies no longer can be the lender where the employee also is an executive officer (or director) of the company. |
| **Swap** |
| If the employer's plan permits it, this strategy makes use of IRC Section 1036, which states, "No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation." In this scenario, the shares owned outright are swapped with the company for those available through the option, without triggering a capital gains tax on the unrealized appreciation on the stock already owned. This eliminates the need for cash to exercise the option; however, cash is needed to pay any required tax withholding if the optionee is an employee or to pay any income tax liability due to AMT (in the case of ISOs).   * **Note Regarding NQSOs** – Since holders of NQSOs must recognize the spread as compensation income at the time of exercise, there is no advantage to this approach over the Cashless Exercise when it comes to NQSOs. Nonetheless, it is possible to do a swap with NQSOs, but the Cashless Exercise is generally preferable because it also provides liquidity for the tax liability. * **Note Regarding ISOs** – Since exercise does not result in recognition of compensation income for ISOs, this approach is more advantageous for holders of ISOs. However, if the shares being tendered were previously acquired via an ISO exercise, then those shares must be “mature” (held for at least one year from the date of exercise and two years from the date of grant) to defer gain recognition on tendered shares.   Once swapped, NQSOs are assigned a basis of FMV at exercise and start a new holding period for capital gains purposes.  With ISOs, however, a number of the optioned shares equal to the number exchanged are assigned the basis and holding period of the previously owned shares. The remaining exercised ISO shares are given a basis of $0. **Click** here **to view an ISO swap example.**   |  | | --- | | **ISO Swap Example – Meet Mr. Carol**  Suppose Mr. Carol has an incentive stock option to purchase 1,000 shares at $10 per share. Thus, he needs $10,000 to purchase the shares. The current market price is $20 per share.  Suppose he already owns 500 shares outright, which he has held for three years, with a basis of $5 per share. He could sell the 500 shares for $10,000 to raise the cash to exercise his option, but would have to pay a long-term capital gain tax on the $7,500 gain. Not only does this trigger a tax, but will leave him short of the required $10,000 he needs to make the purchase.  Instead, he swaps his 500 shares, worth $10,000, for the 1,000 optioned shares. This is known as a tax-deferred exchange because no taxes are triggered by the exchange.  The Internal Revenue Code states that if property is acquired in such an exchange, the basis of the property will be the same as that of the property exchanged. Since the basis in his previously owned shares were $2,500 (500 x $5), the basis of the 1,000 exercised shares will also be $2,500. This basis will be allocated as follows:   * 500 shares with a basis of $5 per share * 500 shares with a basis of $0   In other words, the 1,000 shares are broken out so as to replicate the 500 shares, or the “swapped shares,” he originally owned. Those 500 shares with the $5 per share basis will also inherit his original holding period of 3 years, meaning they can be sold at any time, with appreciation treated as a long-term capital gain once the ISO holding period has been met. The remaining 500 shares will be treated as a new acquisition and their holding period for long-term gains will begin after their acquisition. | |

## Exercise Considerations of Nonqualified Stock Options

We have already discussed some of the unique considerations for exercise of ISOs, particularly as it pertains to managing the AMT exposure. With NQSOs, which trigger compensation income when exercised, there are also unique considerations.

There are differences in opinion regarding the best strategy for the exercise of nonqualified stock options. Many people say to exercise early and hold the stock. This way the spread that is taxed as ordinary compensation income upon exercise is typically small, and the appreciation over time will be subject to the lower capital gains rates. But others criticize this approach, pointing out that the underlying stock can decline in value after the exercise and this eliminates the leverage in the option.

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| **Overview** | There are obviously risks associated with any approach, but before making the decision, there are a number of *primary considerations* to explore. **Click on each primary consideration to view more information.** |
| **Current Liquidity** | Does the NQSO optionee have the liquidity required to pay the option price for the stock, as well as the taxes upon exercise of the option? If not, the only alternative may be a cashless exercise through the broker dealer. With a cashless exercise, the brokerage firm loans the money to make the purchase and then immediately sells part of the stock after exercise to pay off the loan. If, after the cashless exercise, the optionee holds the unsold shares, the optionee’s leverage in the position is significantly reduced, as a significant number of the shares were sold to pay the strike price and the withholding taxes. |
| **Outlook for the Stock** | Does the optionee believe that the stock will continue to appreciate over the next 12 months? If the answer is yes, then there appears to be a sufficient window of opportunity in which to position the future appreciation to be taxed as a long-term capital gain. The risk that should be weighed against this is the possibility of a decline in the stock price and tying up capital in the shares. |
| **Dividend Payment** | If the stock pays a dividend, the option holder will not receive it until the options are exercised and the underlying shares are held. If a significant portion of the stock’s return is in the form of dividends, it may be beneficial to exercise and hold the shares rather than the options. |
| **Need for Diversification** | What percentage of the optionee's net worth is tied up in the underlying stock? If the percentage is high, then he or she may want to consider a strategy that helps diversify the risk of the concentration. |

Once these considerations are made, it then becomes possible to explore which of the following exercise strategies makes sense in a given situation.

**Click each strategy to learn more.**

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| **Possible Tax Advantages of Exercising and Holding the Stock** |
| If the optionee anticipates future appreciation in the stock, the optionee may desire to buy and hold the stock. Of course, this exercise, unlike that for ISOs, will generate a regular income tax and the optionee will need sufficient liquidity to pay that tax if no shares are to be sold. However, if the shares continue to appreciate, the realized gain at an ultimate sale would likely result in lower capital gains taxes (or a possible stepped up basis at death) versus a larger and larger portion taxed as compensation if exercise is deferred into the future. Also, if a stock swap is used to purchase the shares, the purchase can be accomplished with no cash outlay and converts all anticipated future appreciation into a capital gains transaction if/when sold as well as deferring the realization of the gain on the swapped shares (or a possible stepped up basis at death). |
| **Why Not Continue to Hold the Options?** |
| Continuing to hold onto an option once vested has both advantages and risks. The primary advantage is that the option holder has the benefit of a leveraged-type investment that requires no capital outlay. The primary disadvantage to consider is that if the underlying stock continues to appreciate, the option holder could potentially have a higher tax burden upon exercise than if exercised now and held for capital gains treatment on any future appreciation. |

## Stock Appreciation Rights

While very similar to stock options, **Stock Appreciation Rights (SARs)** are another form of option-based compensation. Stock Appreciation Rights have been in existence for some time, but their use has historically been limited due to their accounting treatment, which required that, unlike ISOs and NQSOs, employers must expense the grants. However, when the Financial Accounting Standards Board (FASB) mandated that corporations must also begin expensing ISOs and NQSOs, SARs’ popularity soared as they became equally attractive compensation strategies.

SARs are very similar in form to NQSOs in that they are:

* Granted to employees at a set price.
* Usually subject to a specific vesting schedule set forth under the terms of the company plan, which may be time or performance based.
* Have a defined expiration date.

Once the SARs vest, the employee can exercise them and receive either cash for the amount that the SAR has appreciated above the strike price or, in some cases, for a stock equivalent to that same amount. Whether the SARs are stock or cash settled will be determined by the plan.

The advantage to the employee of SARs over NQSOs lies in the fact that the employee does not have to actually pay to exercise, making the exercise process far easier and less complex financially for the option holder. From a tax perspective, SARs are similar to NQSOs in that the difference between the exercise price and the FMV is taxed as compensation upon exercise.

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| **Overview** | The stages in the life of the grant are listed on the left. **Click each stage to learn more** |
| **Grant** | SARs are granted to the employee. The grant can be either   * A ***Stand-Alone SAR*** is issued independent of any stock options. Thus, it can only be exercised for cash. * A ***Tandem SAR*** is granted in conjunction with a Nonqualified Stock Option or an Incentive Stock Option. This allows the owner to either exercise it for cash (like a Stand-Alone SAR) or exercise it to receive shares of stock. The choice of one eliminates the right to exercise the other. A partial exercise would only result in a partial elimination. |
| **Vest** | Upon vesting, the employee can exercise the SAR at any time prior to its expiration. |
| **Exercise** | The exercise of a SAR will result in the delivery of cash or stock to the employee, the value of which will be based on the difference between the strike of the SAR when granted and the current FMV of the stock when exercised. The spread between the exercise price and FMV is taxed as compensation. |

## Understanding the Mechanics of Exercising SARs

As previously discussed, there are two forms of exercise with SARs, each outlined further below. Below is the scenario we will use to look at the options available under a SARs grant.

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| **SARs Example**  An individual receives 10,000 SARs with a strike price of $10. The vesting period is 3 years on the grant. Five years later, the stock is trading at $20 and the individual decides to exercise the SARs. |

DocumentationIcon_32px**Click the icon to view Option #1.**

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| |  | | --- | | **Option #1: Cash payout** | | * **Grant:** The employee receives 10,000 SARs with a strike price of $10. * **Vest:** The vesting period is 3 years. Given the employee has held the SARs for 5 years, the employee is fully vested and can elect to take the appreciation at any time. * **Exercise:** Given that the stock is trading at $20 at exercise, the employee will receive $100,000 cash (i.e., $200,000 FMV - $100,000 exercise cost) minus tax withholding. | |

DocumentationIcon_32px**Click the icon to view Option #2.**

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| |  | | --- | | **Option #2: Tandem SARs** | | * **Grant:** The employee receives 10,000 SARs with a strike price of $10. * **Vest:** The vesting period is 3 years. * **Exercise**: Five years after grant, the stock is trading at $20 and the employee decides to exercise the SARs. The employee will receive 5,000 shares of stock [i.e., ($200,000 FMV - $100,000 exercise cost) ÷ $20 share price], provided tax withholding is paid in cash by the employee. Alternatively, under most plans, there will be a reduction in the number of shares received by the employee to cover the cost of taxes. * **Sale:** The employee now holds outright the shares received from the SARs grant. Upon ultimate sale of the stock, the tax impact of the sale will be either short-term or long-term gains treatment depending on how long the stock is held from the date of exercise. | |

## Other Forms of Equity-Based Compensation

With the previous detailed understanding of compensatory stock options completed, we now turn to some of the other forms of equity-based compensation strategies that are commonly awarded:

* Restricted Stock (RS)
* Restricted Stock Units (RSUs)
* Performance Shares

While in some respects similar to stock options, there are unique differences in terms of the structure of these various compensation strategies and very significant tax implications that you should be aware of as a financial professional.

Grants of Restricted Stock, Restricted Stock Units, and Performance Shares involve a grant as well as a vesting schedule or vesting condition.

* For **Restricted Stock**, the vesting schedule is time-based, similar to ISOs and NQSOs.
* **Restricted Stock Units** most often are time-based, but some can be subject to performance criteria as well.
* **Performance Shares** are essentially the same as Restricted Stock except for the timing of their vesting or the quantity of shares vesting, which is based on some type of performance criteria.

On the following pages, we will take a closer look at these compensation strategies. As you study these types of equity-based compensation strategies, make sure you understand the structure of the awards, the vesting and exercise strategies related to each, as well as the tax implications and strategies that should be discussed with clients receiving these forms of compensation.

## Grants of Restricted Stock

Grants of **Restricted Stock (RS),** sometimes referred to as **Restricted Stock Awards,** involve an employer granting company stock to employees that is governed by a vesting period during which there are specific restrictions limiting the resale of the stock awarded and which generally provide for forfeiture in the event that the employee quits working for the employer prior to vesting. Vesting periods for Restricted Stock Awards may be time-based (i.e., after a stated period from the grant date). When a Restricted Stock Award vests, the employee receives the shares of company stock without restriction.

Because the shares are subject to a substantial risk of forfeiture, the employee has no immediate tax burden when receiving the award. Once the vesting requirements are met, which are most typically based on maintaining employment with the company for the required timespan, the employee owns the shares outright and can dispose of them at his or her discretion. Since the employee owns the shares free and clear upon vesting and is free to hold or sel the shares, vesting triggers a taxable event. The employee must pay tax on the FMV of the securities at the time the grant vests.

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| **Overview** | For clarity, let’s examine the key stages of Restricted Stock Awards in the same framework we have used in the life of a stock option. **Click each stage to learn more.** |
| **Grant** | The grant is offered and accepted by the employee, who may be required to pay the employer a purchase price on the grant, with restrictions on resale until the grant vests. Due to risk of forfeiture (e.g., if the employee leaves the company prior to vesting), the grant is not a taxable event. |
| **Vest** | The risk of forfeiture lapses upon vesting, thereby triggering a taxable event. The tax is based on the fair market value (FMV) of the securities (less the amount initially paid for the grant, if applicable) at the time the grant vests. This same FMV will be the tax basis of the shares if they are held. |
| **Exercise** | There is no “exercise” with Restricted Stock awards, as the award is made in stock and not as an option to purchase the stock at a given price. |
| **Sale** | The employee can sell the stock award at any time following the vesting. Even if a participant wishes to hold the shares after vesting, a portion of the vested shares will be sold to pay the taxes and the participant will hold the balance of the shares. Should the securities be held for one year and a day from the time of vesting until sale, the incremental value above FMV at vesting would be taxed as a long-term capital gain. Otherwise, it would be taxed as a short-term capital gain. The same logic would apply to a decline in the value of the shares; resulting in long- or short-term capital losses. |

## Section 83(b) Election for Restricted Stock

When an employee receives a grant of Restricted Stock, there are restrictions on the ability to freely resell those securities. Therefore, no tax on this compensation is due at that time. This ability to defer recognition of income is typically beneficial; however, it can also be costly. If, for example, the stock rises in value from the time of the grant to the time the shares vest and are freely sellable, the client will pay ordinary income tax on the total amount of the stock at the time of vesting. The result is a higher tax bill than if the grant would have been taxed immediately upon the grant, with appreciation subsequently taxed as a capital gain.

In situations like this, the client does have an alternative. The client can make what is known as an 83(b) election within 30 days of the time of the grant by informing the IRS of the intent to have the shares taxed at ordinary income rates at the grant date rather than at the vesting date of the Restricted Stock.

Of course, this election is not without risks. For example, it is possible that the stock will decline in value while the restrictions are in place. Furthermore, if after making the election the property is actually forfeited (e.g., because the employee separates from service), the statute does not allow any deduction for the amount that was included in income as a result of the 83(b) election, although it is still possible to recognize a capital loss. For these reasons, the 83(b) election is usually made when there is a strong expectation for appreciation of the stock (e.g,, when the grant is part of an Initial Public Offering (IPO)) or the value of the stock is very low at grant, therefore resulting in a smaller tax bill.

## Example of an 83(b) Election

For clarification, here is an example of an 83(b) election.

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| **83(b) Election Example**  A Restricted Stock Award of 10,000 shares is issued when the stock is trading at $5. The individual makes an 83(b) election on 10,000 shares and pays $17,500 in taxes ($50,000 FMV x 35% tax rate). This also begins the clock for capital gains purposes. Two years later, when the stock vests, the stock is trading at $20. Had the individual not made the 83(b) election, $70,000 in taxes ($200,000 FMV x 35% tax rate) would have been due. Instead, the individual sells the shares at $20 and pays long-term capital gains of $22,500 ($150,000 taxable gain x 15% LTCG). In the scenario where the 83(b) election was made, the total taxes paid are $30,000 less than if the election had not been made. |

An additional benefit of this election is the treatment of dividends. Without the election, any dividend income paid during the vesting period is taxed at ordinary income rates. If the election is made, preferential dividend rates may apply.

Despite the benefits, it is again important to keep in mind that there are risks associated with this election. As previously mentioned, the election cannot be reversed. If the stock price declines or the award is forfeited, the individual may end up having paid more in taxes than would have been due otherwise. Additionally, if liquidity is an issue, deferral of all taxes until vesting means that the taxable event will take place at a time when shares can generally be sold to pay the taxes. If, however, the election is made prior to vesting, then the shares are not available for sale and the individual will have to finance the payment of the taxes through some other means.

Another important point is this election can only be made on actual shares. Hence, this 83(b) election strategy is irrelevant for Restricted Stock Units and for some types of Performance Shares.

## Restricted Stock Units (RSUs)

Another form of equity-based compensation similar to Restricted Stock Awards is the granting of Restricted Stock Units. While almost the same form of compensation as Restricted Stock, the difference is that the grant is not actual shares of stock, but rather “unit” that represents a certain amount of company stock. Upon vesting, the employee receives either stock or cash as defined by the plan. In some plans, the employee has the option of choosing stock or cash.

The value of RSUs is tied directly to the price of the company’s stock. In the case of a dividend-paying stock, the RSU has no dividend rights. However, if the company decides it would like to pay a dividend on RSUs, the company has the ability to issue ***Dividend Equivalent Units (DEUs),*** which allows the company to distribute additional RSUs equal to the amount of the dividend paid.

Unlike stock options, there is no exercise with RSUs. Upon vesting, the individual simply receives shares or cash, and will have a taxable event at that time. The tax due will be calculated on the FMV at vesting and is taxed as ordinary income. The vesting schedule for RSUs may either be time-based (i.e., at the end of a specific period of time) or performance-based (e.g., based upon achievement of corporate goals). Once vested, the person generally receives shares of the company or the cash equivalent (depending upon the rules of the plan), although some plans may allow or require deferment until a later date.

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| **Overview** | For clarity, let’s examine the key stages of Restricted Stock Units in the same framework we have used previously. **Click each stage to learn more.** |
| **Grant** |  |
| **Vest** |  |
| **Exercise** |  |
| **Sale** |  |

## Taxation of Restricted Stock Units

As previously identified, there is no formal “exercise” with RSUs. Upon vesting in the RSUs, the individual simply receives the shares (or cash equivalent) and the tax liability is recognized (unless receipt of the securities is deferred). If receipt is deferred, the individual must pay a statutory minimum tax, as determined by the employer at vesting, but all other taxes are deferred until actual receipt of the stock or cash. This is a strategy that is most commonly used when a senior executive at a firm vests in RSUs.

Unless an amount is paid by the individual for the shares, which is very rare, the entire value of the stock upon receipt is taxed as ordinary income. If a payment is required, the difference between that amount and the FMV at vesting is taxed as ordinary income. In either case, the cost basis becomes the FMV at vesting.

## Employee Stock Options vs. Restricted Stock Awards

There are several reasons why a company would issue Restricted Stock (RS) or Restricted Stock Units (RSUs) instead of Employee Stock Options (ESOs). First, unless the company stock goes to zero, both Restricted Stock Awards and RSUs always have value. Employee Stock Options, on the other hand, can go “underwater,” or said another way, the FMV can fall below the strike price, thereby eliminating the intrinsic value.

Although the leverage imbedded in Executive Stock Options is very attractive, it is only of value if the stock price is appreciating, as the FMV must increase above the strike to generate revenue from the award. For companies whose stock price is flat or declining, Restricted Stock and RSUs provide a greater award than ESOs. Restricted Stock and RSUs are also a lot simpler to communicate to employees than ESOs, as there is no exercise decision, no need for financing, and no complex AMT issues.

## Addressing Concentration in Company Stock

As previously discussed, individuals who received equity compensation are frequently concentrated in the company stock. If the goal is diversification, RS and RSUs should generally be sold at vesting. In addition to providing liquidity for diversification, it will also provide the funds necessary to pay the taxes which will be due at vesting.

In the case where the individual has multiple forms of company stock, the order of diversification is generally as follows:

* Sell RS or RSUs at vesting
* Sell long shares
* Exercise and sell NQSOs
* Exercise ISOs, sell if concentration is severe, hold if tax benefits make the additional risk worthwhile and the outlook on the stock is positive

Keep in mind, each situation is unique and these are just general guidelines. It is suggested you discuss the specifics of the client’s position with a specialist to determine the appropriate course of action.

## Protecting Large Concentrations of Stock

Option holders are often subject to the risk associated with large concentrations of company stock. While this risk exists prior to execution of the option, particularly if the stock has appreciated considerably in value, it is more acute if the options have been exercised and the stock is being held.

Generally speaking, hedging strategies are a means of providing such protection. However, when dealing with compensatory options, a host of issues must be considered. Among these considerations are the following:

* Many companies ban employees from utilizing hedging strategies on company stock.
* If the owner is a company insider, then the short swing rules come into play, which could impact future flexibility in trading the securities.
* Hedging strategies can prevent dividends from being taxed as “qualified dividends.”
* Hedging strategies may introduce additional complex tax issues, such as constructive sale rules.

Therefore, when a client seeks to hedge the risk associated with a concentrated position, recognize that this is a complex enterprise that is well beyond the scope of this course. Pursuing such a strategy should not be done without the involvement of the client's tax advisor and other professionals with specific expertise in this area.

## Review Exercise

## Conclusion

Equity awards are, and continue to be, a core part of executive compensation. Additionally, many other people receive these awards, such as directors, consultants, and even employees below the executive level. It is important to have a working knowledge of these awards in order to assist your clients with the multiple decisions surrounding them.

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| Upon completing this course, you should have a clear understanding of the following important topics:  **ISOs**   * The Structure of ISOs * Tax implications at each significant stage with the option: Grant, Vest, Exercise, and Sale of the underlying stock * Disqualifying Distributions * AMT tax implications of ISO exercise   **NQSOs**   * Structure of NQSOs * Tax implications at each significant stage with the option: Grant, Vest, Exercise, and Sale of the underlying stock. * Exercise strategies and alternatives   **Other Forms of Equity Compensation**   * Stock Appreciation Rights   + Structure of SARs   + Tax implications at each significant stage with the option: Grant, Vest, Exercise, and Cash distribution or Sale of the underlying stock.   + Exercise strategies and alternatives * Restricted Stock and some types of Performance Shares   + Tax implications at Grant, Vest, and Sale   + The mechanics of 83(b) elections, advantages and risks to be considered * Restricted Stock Units and some types of Performance Shares   + Tax implications at Grant, Vest, and Sale   + Cash vs. stock settled   + Dividend Equivalent Units |