COMPENSATORY STOCK OPTIONS

Many employers grant stock options to employees as part of their compensation packages. From the tax standpoint, there are two kinds of options -- statutory and nonstatutory. "Incentive Stock Options," or ISOs, as they are commonly known, are statutory options, because they are specifically provided for in the Internal Revenue Code (IRC) and are subject to numerous qualification requirements. Options which don't meet these requirements are nonstatutory options, also known as nonqualified options. Both kinds of options have tax advantages, but there are quite a few differences between them.

Here's some basic information on the taxation of compensatory stock options which may help you better understand how best to benefit from them.

- **Statutory vs. nonstatutory options**

  The tax consequences for both employer and employee depend on whether the options are statutory or nonstatutory.

  - A statutory option is an option that meets requirements set forth in the IRC. Statutory options include incentive stock options (ISOs) and options issued under employee stock purchase plans. However, this Hot Topic's discussion of statutory options generally refers only to ISOs. There are no tax consequences on the grant of statutory options to an employee. Nor does an employee have income for regular income tax purposes when a statutory option is exercised and stock of the employer is transferred to the employee. However, the bargain element, that is, the difference between the exercise price and the option stock's value at exercise, is an AMT adjustment. Since employees are not subject to regular income tax on either the grant or the exercise of statutory options, the taxable event is the sale of the stock acquired through the exercise of the statutory option. The income realized on the sale of the option stock is all capital gain, provided certain holding periods are met. If the holding periods aren't met, some of the profit is ordinary income.

  - A nonstatutory option is a compensatory stock option that does not meet the requirements for incentive stock options or employee stock purchase plan options. A nonstatutory stock option is taxed to the employee at its grant if it has a readily ascertainable fair market value at that time. If the option's value at grant isn't readily ascertainable, tax is imposed at ordinary income rates at the time the option is disposed of or exercised, or, if later, when the option stock becomes transferable or is no longer subject to a substantial risk of forfeiture.

  From an employee's standpoint, the main differences between statutory and nonstatutory options are the timing of the income received and the character of that income. Recipients of nonstatutory stock options generally are taxed at ordinary income rates on option exercise, and later gain on the stock is capital gain. Recipients of statutory options may be subject to AMT (but not regular income tax) on option exercise. If AMT isn't owed, no tax is due until the option stock is sold at which time any gain is subject to capital gain rates providing certain holding period requirements have been met.

- **Option grant**

ISOs are not taxed on option grant. Nonstatutory options are taxed on option grant but only if they have a "readily ascertainable" fair market value at grant, which is seldom the case. IRS rules say that options don't have a readily ascertainable value at grant unless they are actively traded or are immediately transferable, fully exercisable, and the options and the option stock are unrestricted. In addition, the value of the "option privilege" must be readily ascertainable. In the unlikely event that a nonstatutory option is taxable at grant, compensation income arises at that point.

- **Option exercise**

No regular income tax is owed on the exercise of an ISO. Tax isn't owed until the stock is sold. However, the bargain element at exercise, is considered income for purposes of the alternative minimum tax (AMT). Even if you're usually not subject to the AMT, exercising ISOs may push you into its range. If you are subject to the AMT in the year you exercise ISOs, you may be entitled to a tax credit against your regular income tax in some later year when you're not subject to AMT.

When you exercise a nonqualified option that wasn't taxed at grant, you're subject to tax at ordinary income rates on the difference between the value of the option stock at the time of exercise and the price you paid for it (plus any price you may have paid for the option, although generally that will be zero). This is compensation income which is subject to payroll taxes and income tax withholding for the year of exercise. Taxes may be withheld from your salary or other compensation income, or you may have to sell some of the stock to cover the withholding or make some other arrangement with your employer. However if the option stock is nontransferable or subject to a substantial risk of forfeiture, you aren't charged with compensation income until those restrictions no longer exist. In that case, you can choose to pay tax on exercise so that all gain from that point on would be capital gain.

- **Sale of option stock**

When you sell stock acquired through the exercise of an ISO, you generally are taxed at favorable long-term capital gain rates (i.e., maximum rate of 15%) on the difference between the price you paid for the stock and the amount you realize on its sale. However, if you sell the stock within two years of the option grant or within one year of the option exercise, you're hit with compensation income to the extent of your bargain element at exercise. The balance of your gain is capital gain, which will be taxed at the favorable rates if you've held the stock for more than one year on the sale date.

When you sell stock acquired by exercise of a nonqualified option, you have capital gain if you were subject to tax either at option grant or exercise, or when restrictions on your option stock lapsed. Otherwise, you have compensation income at the time of the sale.

- **Gifts of options**

Some people would like to give stock options to family members as part of their overall estate planning. (Transferring property before it increases in value helps lower or eliminate estate and gift taxes.) This can't be done with ISOs, because they can't be transferred during the optionee's lifetime and can't be exercised by anyone but the optionee during his or her life. Nonqualified options have an edge here if the option plan allows options to be transferred to family members, as many plans now do. However, the IRS has ruled that an option transfer isn't complete for gift tax purposes until the option is no longer conditioned on the performance of future services. That usually means the gift will be subject to gift tax at a time when the option's value has increased. If you do make a gift of a nonqualified option, you won't shift the compensation income from it's exercise to the donee. You will be charged with some compensation income at the time of transfer, and will pick up the rest when the donee exercises the option. IRS also has issued some complicated rules for valuing gifts of nonqualified stock options.

- **Transfers in divorce**

  Nonstatutory options but not ISOs can be transferred in a divorce. The transfer itself isn't taxed. Rather, the transferee spouse will be taxed usually on exercise at which time social taxes also may be triggered and withheld from the payment to the transferee spouse.

- **Employer's tax consequences**

  Employers are entitled to compensation expense deductions in connection with nonstatutory options. If an employee has compensation income through the grant, disposition, or exercise of a nonstatutory option, the employer is entitled to a deduction under the Code Sec. 83 rules that apply to the transfer of property for the performance of services. The deduction is allowable for the tax year in which the employee includes the compensation in income. No deduction is available where an option or stock is transferred to an employee in a transaction that is subject to the rules for statutory stock options. However, a deduction is available if and when an employee makes a disqualifying disposition of statutory option stock, that is, a disposition before required holding periods are met.