

The ABC's of Taxing Stock-Based Compensation

By Jonathan M. Cerrito

Employees, in particular executives, may be covered by a wide range of compensation arrangements. These compensation arrangements may



involve, for example, tax-qualified pension and retirement plans, health and welfare plans, nonqualified deferred compensation, life insurance and stock-based compensation.

Stock-based compensation, a commonly used form of executive compensation, may include stock, restricted stock, stock options, stock appreciation rights and phantom stock.¹ Employers may provide stock-based compensation to employees pursuant to a formal plan, an individual's employment contract or both. In addition to employees, non-employee service providers, such as outside directors, may also receive stock-based compensation.²

This article discusses the federal income tax consequences to an employee or service provider who receives a grant of employer stock or stock options.³

I. Grants of Stock

Internal Revenue Code § 83 applies to stock granted to an employee because the stock is property transferred in connection with the employee's performance of services. In addition, I.R.C. § 409A also applies to stock grants where, for example, the grant is generally being used as a means for an employee to postpone paying income tax beyond the date when the employee has a right to the stock.

A. Internal Revenue Code § 83

Under I.R.C. § 83, whether an employee will be subject to immediate taxation at the time of receiving stock will depend on whether the employee's right to the stock is subject to a substantial risk of forfeiture. Stock that is subject to a substantial risk of forfeiture has been coined nonvested stock, whereas stock that is not (or is no longer) subject to a substantial risk of forfeiture is referred to as vested stock.⁴ Generally, an employee receives nonvested stock if the employee's right to the stock is conditioned upon the future performance of substantial services or the occurrence of a performance-related condition.⁵ Additionally, the possibility that the employee might lose rights to the stock must be substantial.⁶

Vesting may be thought of as having a secured right of present or future enjoyment where the employer may not take the stock back from the employee (well . . . at least not without paying fair market value for it). An employee may be vested and have a secured right to stock even though the employee does not have actual possession of the stock. On the other hand, stock that may be forfeited under certain conditions, such as termination of employment, will not be considered vested because there is a real possibility that the employee might lose any future right to the stock. Ultimately, the facts and circumstances surrounding the terms of the grant determine whether the employee is vested.⁷

If an employee receives vested stock, then the employee will have to include income, in the year of receipt, equal to the excess of the fair market value of the stock over the amount, if any, that the employee paid for the stock.⁸ However, if an employee receives nonvested stock, then income inclusion is deferred until the year

in which the stock vests unless the employee makes an affirmative election to include income in the year of receipt.⁹ If an employee does not elect otherwise, then in the year the stock vests, the excess of the fair market value of the stock at the time of vesting over the amount, if any, that the employee paid for the stock is includible in income.¹⁰

An employee who receives nonvested stock may choose not to defer income inclusion and instead affirmatively elect to include, in the year of the receipt, the fair market value of the stock over the amount, if any, that the employee paid. An employee may make such an election no more than thirty (30) days after receiving stock.¹¹ Although it seems counterintuitive to elect to be taxed now versus later, there may be limited circumstances under which an employee may benefit from being taxed in the year of receipt.

One benefit of making such an election is that appreciation earned thereafter will be taxed at a capital gains rate (generally 15%) as opposed to ordinary income tax rates (generally 28%-35%). However, if after making an election and paying tax a forfeiture event occurs—an event that would cause the employee to lose his or her rights to the stock—the employee is not entitled to a tax deduction for the amount of tax previously paid. Thus, the downside of such an election is that the employee carries increased risk of losing not only rights to the stock but also the money expended to pay tax. It is for this reason that employees generally avoid elections to include income in the year that stock is received.

Nevertheless, an employee, in some instances, may benefit from making an election—for example, where the amount of income the employee expects to report as a result of the election is small and the potential

growth in the value of the stock is great. Or, where the employee expects reasonable growth in the value of the stock but the likelihood that a forfeiture event will occur is small. In these circumstances, the risk associated with an election is contained because there is either less tax paid or a small chance that the employee will lose rights to the stock. Weigh this more limited risk against the benefits of being taxed at a lower (capital gains) rate and employees in these circumstances may reasonably consider electing taxation in the year of receipt.

B. Internal Revenue Code § 409A

Stock grants should be structured to comply with I.R.C. § 409A unless the employee will suffer adverse tax consequences that include immediate income inclusion, a 20% penalty tax and interest. A grant of stock will be subject to the rigid rules of I.R.C. § 409A if, for example, the stock is not actually paid to the employee upon vesting. It is emphasized that the unusually severe consequences for violating I.R.C. § 409A are levied against the employee even though it is the employer that fails to comply.

II. Grants of Stock Options

A stock option is generally an award under which an employer grants an employee the right to buy employer stock at a certain price within a set period of time. The privilege associated with receiving options to buy stock is “the opportunity to benefit during the option’s exercise period from any increase in the value of the stock without risking any capital.”¹²

Under the Internal Revenue Code, there are two general types of stock options: nonqualified options and statutory options.¹³ Statutory options include options provided under an employee stock purchase plan and incentive stock options (“ISOs”).¹⁴ Any other options granted in connection with the performance of services are nonqualified options.¹⁵

Nonqualified stock options may be granted either to an employee or non-employee service provider; whereas, statutory options may be granted only to employees.¹⁶ Additionally, nonqualified stock options by definition are not subject to the rigid requirements that statutory options are. However, in return for conforming to Internal Revenue Code requirements, statutory options receive favorable tax treatment. The favorable tax treatment generally associated with statutory options is the employee’s ability to exercise the option, receive vested stock and not realize income until the employee sells the stock.

A. Nonqualified Stock Options

Internal Revenue Code § 83 applies to grants of nonqualified stock options because stock options granted to employees are generally considered to be compensation for services. In addition, I.R.C. § 409A also applies to certain grants of nonqualified stock options.

1. Internal Revenue Code § 83

The tax consequences to an employee who receives nonqualified stock options depends on whether or not, at the time of grant, the option has a readily ascertainable fair market value. Generally, in most cases nonqualified options, at the time of grant, do not have readily ascertainable fair market values.¹⁷

Although nonqualified options have some value at the time of grant, ordinarily that value is not readily ascertainable unless the option is actively traded on an established market.¹⁸ If a nonqualified option is not traded on an established market, to have a readily ascertainable fair market value the options must be transferable and immediately exercisable in full. Additionally, the stock subject to the option must not be subject to any restriction or condition which has a significant effect upon the fair market value of the option. Furthermore, the fair market value of the option privilege must be readily

ascertainable.¹⁹ The option privilege, as noted above, is the opportunity to benefit during a given period from increases in stock price without risking any money. These legal requirements generally highlight the reason why most nonqualified options that are not actively traded on an established market do not have readily ascertainable fair market values.

An employee has no includible income upon receiving a nonqualified option that has no readily ascertainable fair market value. Instead, I.R.C. § 83 will apply in the year when the employee exercises the option. If the employee receives vested stock on exercise, then, in the year of exercise, the excess of the fair market value of the stock over the option price is includible in the employee’s income.²⁰ If the employee receives nonvested stock on exercise, then in the year the stock vests the employee will have income unless the employee makes an affirmative election to include income in the year the option is exercised.²¹ If the employee does not elect otherwise, then, in the year the stock vests, the excess of the fair market value of the stock at the time of vesting, over the option price, is includible in income.²²

Upon receipt of a nonqualified option with a readily ascertainable fair market value, the excess of the fair market value of the option over the amount, if any, that the employee paid is includible in income in the year the stock option vests.²³ Thus, unless an employee affirmatively elects to include income in the year of receipt, such employee will not be subject to tax until the year when the employee has a vested right to the stock option.²⁴ Because the employee will have income inclusion in the year of vesting, such employee will have no includible income upon exercising the option.

2. Internal Revenue Code § 409A

Internal Revenue Code § 409A applies to nonqualified stock options that, for example, have an exercise price below fair market value of

the stock, include a feature to defer income beyond vesting or where the underlying stock subject to the option is stock other than common stock. While there are no prohibitions on granting stock options subject to I.R.C. § 409A, the options must be properly structured unless the employee will be subject to immediate income inclusion, a 20% penalty tax and interest.

B. Statutory Stock Options

Statutory options may be granted to employees but not service providers. As noted above, statutory options include options provided under an employee stock purchase plan and ISOs.²⁵ An ISO is an option that provides an employee with the right to purchase employer stock and that meets the requirements of I.R.C. § 422.²⁶ An employee stock purchase plan is a plan that grants stock options to purchase employer stock and that meets the requirements of I.R.C. § 423.²⁷

Statutory options are not subject to the complex tax scheme of I.R.C. §§ 83 and 409A. Instead, the general rule may be simply stated: An employee does not recognize income upon receipt or exercise of a statutory option.²⁸ That is, there are no tax consequences to an employee who receives statutory options until the employee *disposes* of the underlying stock subject to the options. Generally, a disposition of the stock includes a sale, exchange, gift or any transfer of legal title.²⁹

At the time of disposition, the employee is taxed on the excess between the fair market value of the stock at disposition over the option price that the employee paid. Whether the includible amount of income is subject to tax at ordinary income rates or capital gain rates will depend on whether the employee satisfied the holding period requirement. An employee's disposition of stock

within either two (2) years after the date the option is granted or one year after the date the stock is transferred to the employee (i.e., the option is exercised) is known as a "disqualifying event." If the disposition is pursuant to a disqualifying event, the employee does not qualify for capital gains treatment. Instead, the employee includes income realized on the disqualifying event as compensation subject to ordinary income tax rates.

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III. Conclusion

While only scratching the surface of possible compensation arrangements, this article highlights the current complexity of taxing stock-based compensation. Minor structural differences can dramatically change the tax consequences associated with the receipt of stock and stock options. In addition to losing the ability to control the timing of taxation, employees also run the risk of suffering severe penalties and having to pay interest on tax owed. This is also an issue for employers—striving to attract talent while keeping current employees happy—to consider when designing the terms of such grants.

Endnotes

1. An employer may also use its stock in connection with a tax-qualified defined contribution or defined benefit pension plan.
2. Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-39-06), September 5, 2006 at page 32.

3. Unless otherwise indicated, the use of the term *employee* throughout this article includes non-employee service providers.
4. Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-39-06), September 5, 2006 at page 33, footnote 63.
5. Treas. Reg. § 1.83-3(c)(1).
6. *Id.*
7. *Id.*
8. I.R.C. § 83(a).
9. I.R.C. § 83(a) and (b).
10. *Id.*
11. I.R.C. § 83(b)(2).
12. Treas. Reg. § 1.83-7(b)(3).
13. Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-39-06), September 5, 2006 at page 34.
14. *Id.* at page 34.
15. *Id.* at page 34.
16. *Id.* at page 35.
17. *Id.* at page 34.
18. Treas. Reg. § 1.83-7(b)(1).
19. Treas. Reg. § 1.83-7(b)(2).
20. I.R.C. § 83(a).
21. I.R.C. § 83(a) and (b).
22. *Id.*
23. I.R.C. § 83(a).
24. I.R.C. § 83(a) and (b).
25. Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-39-06), September 5, 2006 at page 34.
26. *Id.* at page 35.
27. *Id.* at page 36.
28. I.R.C. § 421 and Treas. Reg. § 1.421-2(a)(1)(i).
29. Treasury Regulation § 1.424-1(c) outlines certain transactions that are not considered dispositions.

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