



Taxation of Stock Options and Restricted Stock: The Basics and Beyond

LIFE SCIENCES LAW, PLLC

870 Martin Luther King, Jr. Blvd.
Chapel Hill, NC 27514
www.LifeSciLaw.com

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➤ **Incentive Stock Options**

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Overview of ISOs

- ✓ No income tax upon grant
- ✓ No income tax upon exercise
- ✓ Pay tax when stock sold
- ✓ Example:

Kurtis exercises 1,000 ISOs and receives 1,000 shares.

Exercise price = \$10 per share.

Three years later, he sells the stock for \$15 per share.

He pays no tax until he sells the shares.

Overview of ISOs

- ✓ Gains are taxed at capital gains rates.

Example:

Kurtis exercises 1,000 ISOs and receives 1,000 shares. Exercise price = \$10 per share. Three years later, he sells the stock for \$15 per share.

ISO capital gain calculation:

Sales price per share		\$15
Minus exercise price		<u>\$10</u>
Equals gain per share		\$ 5
Times # of shares sold	x	<u>1000</u>
Equals total capital gain (L/T)		<u>\$5,000</u>

Disqualifying Dispositions

Disqualifying disposition if stock is sold within:

- ✓ 2 years after ISO granted or
- ✓ 1 year after ISO exercised
- ✓ Causes loss of favorable ISO tax treatment
- ✓ Requires income to be reported in the year of the disqualifying disposition.
- ✓ Income = spread at exercise.
- ✓ Example: Kurtis exercises 1,000 ISOs when the current stock value is \$12. Exercise price = \$10 per share. 6 months later, he sells the stock for \$15 per share.

Stock value at exercise date	\$12
Minus exercise price	- 10
Equals spread (ordinary income)	\$ 2
Times number of shares sold	x 1,000
Equals total ordinary income	\$2,000

Disqualifying Dispositions

- ✓ In addition, Kurtis will report a capital gain upon the sale of the stock

Sales price		\$15
Minus Brian's basis in the stock:		
Exercise price	\$10	
Ordinary income (from DD)	2	- 12
Equals capital gain		\$ 3
Times number of shares sold		x 1,000
Equals total capital gain (short-term)		\$3,000

Disqualifying Dispositions

- ✓ If the stock value declines after exercise, Kurtis will not recognize any capital gain or loss because his entire gain on the stock (i.e. difference between sale price and the exercise price) has already been recognized as ordinary income.

Example: Brian exercises 1,000 ISOs when the current stock value is \$12. Exercise price = \$10 per share. **Only 6 months later**, he sells the stock for \$11 per share.

ISO ordinary income calculation

Sales price per share	\$11
Minus exercise price	-10
Equals spread (ordinary income)	\$ 1
Times number of shares sold	x 1,000
Equals total ordinary income	\$1,000

Alternative Minimum Tax

- ✓ If Kurtis exercises lots of ISOs and the stock value has increased dramatically, he may have a substantial AMT liability.
- ✓ If the stock later plunges in value before he sells it, Kurtis will have incurred a large tax bill on phantom (unrealized gains).

Example: When Brian exercised the 1,000 ISOs for \$10 per share, the fair market value of the stock was \$12.

AMT preference = Spread at exercise

Stock value at exercise date	\$12
Minus exercise price	-10
Equals spread	\$ 2
Times number of ISOs exercised	x 1,000
Equals AMT preference amount	\$2,000

Minimizing AMT Impact

- ✓ Limit the number of ISOs exercised in any given year.
 - ✓ *Calculate the amount of ISOs to exercise in a given year that will cause the regular tax and the AMT to be equal amounts (i.e., Alison will not be paying AMT).*
 - ✓ *Estimate how many ISOs can be exercised in each future year without triggering AMT.*
 - ✓ *Update the plan each year to reflect changes in stock value.*
 - ✓ *Exercise ISOs as early in the year as possible, and monitor the price throughout the year.*
 - ✓ *If the stock price decreases during the year and it appears that this decline may continue, then sell the shares.*
 - ✓ *Results in a disqualifying disposition, but eliminates the AMT preference and avoids paying tax on phantom income.*
 - ✓ *If the stock price increases and it appears that this increase may continue, then hold the shares.*
 - ✓ *Avoids paying AMT on phantom income.*

ISO Requirements

- ☑ Option term cannot exceed _____.
- ☑ Exercise price cannot be less than fair market value of the stock on the date of grant.
- ☑ Option is not transferable (except upon death).
- ☑ Employees to whom the option is granted _____ of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation
 - This rule is waived if the exercise price is 110% of fair market value of the stock on grant date, and option term is limited to five years from grant date.

Note: There are additional requirements



➤ **Non-Qualified Stock Options**

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Non-Qualified Stock Options

- Kurtis also holds 100,000 **nonqualified** stock options.
- Nonqualified options are basically any options that do **not** meet the requirements to qualify as ISOs.
- The tax rules for NSOs are **simpler** than for ISOs!
 - Like ISOs, **no tax** upon **grant**
 - **Unlike** ISOs, there is tax upon **exercise**

$$\text{Income amount upon exercise} = \text{Stock value at exercise date} - \text{Exercise price}$$

Non-Qualified Stock Options

Kurtis exercises 10,000 nonqualified stock options in Year 1.

Exercise price = \$10 per share

Stock value on exercise date = \$15 per share

Kurtis sells the stock in Year 10 for \$50 per share.

- Income recognized by Jane upon exercise in Year 1

Total income = \$5 x 10,000 shares = \$50,000

- This is treated as compensation, and is **ordinary income**.
- Note: Company gets a \$50,000 tax deduction.

Stock value on exercise date	\$15
Minus exercise price	- 10
Spread at exercise date	\$ 5

Non-Qualified Stock Options

Kurtis exercises 10,000 nonqualified stock options in Year 1.

Exercise price = \$10 per share

Stock value on exercise date = \$15 per share

Kurtis sells the stock in Year 10 for \$50 per share.

- Income recognized by Brian upon sale in Year 10

Total gain = \$35 x 10,000 shares = \$350,000

- This is a **capital gain (long-term)**.

Stock value on exercise date	\$50
Minus exercise price	- 10
Minus spread at exercise date	- 5
Gain upon sale	\$35