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Stock option planning: Generating value

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Annually, millions of Americans are granted stock options by their employer. The majority of recipients are high-net-worth individuals (or soon will be). The positive impact of this wealth-creation event on a client's life can be amplified with the implementation of sound and prudent planning. The tax treatment upon the exercise of options and the subsequent sale of the underlying shares can vary greatly depending on the option type. However, regardless of the type, all stock option planning has a common goal: to maximize the value generated for the option holder.

The meaning of the term "value" may not be the same for all clients. For some of them, value may be defined as maximizing cash from the sale of the stock or minimizing taxes. Other clients may wish to limit their cash outlay upon exercise of the options. Still others may seek to hold a large equity stake in the issuing company. Not only is it important to understand the tax ramifications of these events, but also it is equally important for the CPA, as the trusted adviser, to proactively use this information to develop a long-term plan that assists clients in realizing all potential value in line with their ultimate goals.

There are generally two classifications of stock options: (1) nonqualified stock options (NQSOs) and (2) qualified stock options, which are more commonly known as incentive stock options (ISOs). The principal difference between these two categories is their treatment for income tax purposes.

Nonqualified stock options

NQSOs are the right to purchase shares of stock at a specified exercise price within a certain period. In most cases, a grant of NQSOs is not a taxable event for the recipient. However, in the relatively rare circumstances where an NQSO has a readily ascertainable fair market value (FMV) on the date of grant, such as where the options are actively traded on an established market, they are taxed upon grant, and the recipient has ordinary income equal to the FMV on the date of grant of the option received less the exercise price paid.

Generally, NQSOs that do not have a readily ascertainable FMV at the time of grant are taxed upon exercise. In most cases, they are not exercisable until the underlying stock vests, with vesting occurring pursuant to a plan document approved by the issuing company. If stock is vested at the time NQSOs are exercised, the option holder has ordinary income in the amount of the bargain element in the stock received, which in this case is the stock's FMV at exercise minus the exercise price paid.

However, in some cases, the stock received when NQSOs are exercised is not vested because the stock is subject to a substantial risk of forfeiture. In this situation, if a Sec. 83(b) election is not made, the taxable event occurs when the substantial risk of forfeiture lapses and the stock vests and the taxpayer again has ordinary income in the amount of the bargain element in the stock, which in this case is the stock's FMV on the date the stock vests less the exercise price paid.

A special tax rule applies if at least 80% of the company's U.S.-based employees are granted stock options during the calendar year and certain other conditions are met. In that event, eligible employees can elect to defer the recognition of income from exercising stock options for up to five years (Sec. 83(i); Notice 2018-97). However, for most clients, a five-year deferral of income tax consequences will not be an available choice.

NQSO planning

Most planning strategies associated with NQSOs are mechanically simple. However, this does not mean those strategies cannot yield a substantial benefit. The following are some common courses of action associated with NQSO planning:

Exercise and sell

For risk-averse clients who want to minimize exposure to a concentrated position, or who simply do not wish to tie up substantial amounts of cash, exercising their options and immediately selling the underlying shares may be a viable strategy. Upon exercise, the bargain element will be taxable to the option holder as ordinary income. The basis in this stock will be the exercise price paid plus the income recognized at exercise. The capital gain or loss, if any, associated with the immediate sale of the shares will be short-term in character.

Exercise and hold

Some clients have a higher tolerance for concentrated positions and will want to hold the stock to capture appreciation in the company's value. This could be an attractive choice, as, after the initial inclusion of ordinary income upon exercise, appreciation in the stock price will be taxed as a long-term capital gain, assuming the holding period requirement is met.

Exercise and partial sell/partial hold

The two strategies discussed above may not independently capture the value that all clients seek. An alternative is immediately selling a certain portion of the stock and holding the rest for long-term appreciation. This is commonly done to raise cash to pay taxes associated with the exercise. This will somewhat minimize capital outlay while allowing for the potential capture of future growth in the stock's value.

Sec. 83(b) election

In certain situations, where a taxpayer receives substantially nonvested NQSOs with a readily ascertainable FMV at grant, there can exist an opportunity to make a Sec. 83(b) election. A Sec. 83(b) election allows the taxpayer to include the bargain element of the stock received at the time the NQSOs are granted (i.e., the FMV of the stock at the time of grant less the exercise price paid) in gross income as ordinary income. This is an alternative to the standard NQSO treatment that includes the bargain element in income at the post-vesting exercise date of the options.

Under the election, any appreciation of the stock, beyond the FMV at the time of the election, will be taxed at preferential capital gains tax rates rather than ordinary rates. In some cases, this could result in a large income tax savings. It is important to note that the election must be made no later than 30 days after the property transfer, and if the stock received is later forfeited, no deduction or refund of tax previously paid is allowed. Careful analysis and research should be done before making the election.

Gifting

A unique opportunity associated with NQSOs is the ability to gift the options. Unlike Sec. 422, which governs ISOs, Sec. 83 does not require the exerciser or holder of the option to be an employee of the issuing company. Additionally, Sec. 83 permits the transfer of vested options. The bargain element income from the exercise will be recognized by the individual who performed the services to earn the options. The donee will not be subject to income tax on this amount. The tax paid is not a taxable gift to the donee, as it is a personal liability of the donor. The issuing company's plan must allow for gifting of such options.

Incentive stock options

ISOs are similar to NQSOs in that they represent a right to purchase shares at a specific price within a certain period. However, unlike NQSOs, ISOs are eligible to receive preferential tax treatment under Sec. 421. For the option holder to reap these benefits, the options must qualify as ISOs under Sec. 422 and must be disposed of in a qualifying disposition.The following list illustrates some of the requirements that must be met for an option to be an ISO:

- The options must be granted pursuant to a shareholder-approved plan. The grants must occur within 10 years of the date on which the plan was adopted or approved by shareholders, whichever is earlier. Additionally, the options may not be exercisable after the expiration of 10 years from the date of grant.

- The individual to whom the ISOs are granted, at the time the options are granted, must not own greater than 10% of the total combined voting power of all classes of stock of the issuing company or of its parent or subsidiary corporation.

- The value of ISOs becoming exercisable for the first time in any calendar year cannot exceed $100,000.

This list is not all-inclusive, but it provides a general idea of the types of rules that must be complied with for an option to qualify as an ISO.

To be a qualifying disposition for ISO purposes:

- The disposition (sale) of the ISO stock must take place more than two years after the grant date and more than one year after the exercise date.

- At all times during the period beginning on the date of the granting of the option and ending on the day three months before the date of exercise, the individual exercising the ISO was an employee of either the corporation granting the option; a parent or subsidiary corporation of the corporation; or a corporation, or its parent or subsidiary, that has issued or assumed a stock option in a Sec. 424(a) transaction.

ISO tax treatment

Qualifying disposition: If options that meet the requirements to be ISOs are disposed of in a qualifying disposition, the owner of the ISOs will receive the following tax treatment upon exercise of the options and the subsequent sale of the stock:

- Upon exercise of the ISO, there is no event for regular tax. However, there is a positive alternative minimum tax (AMT) income adjustment in the amount of the bargain element in the stock at the time of exercise (the FMV of the stock at the time of exercise less the exercise price paid). For example, if the option has an exercise price of $10 and the stock's value is $25 at the date of exercise, the bargain element of $15 per share will be included in AMT income in the year of exercise but not in regular taxable income.
- Upon the qualifying disposition of those shares, if the basis of the ISO stock for regular tax purposes (the price paid to exercise the ISO) is less than the disposition price of the stock, the taxpayer will have long-term capital gain income for regular tax purposes. There also will be an AMT income adjustment for the difference between the regular tax basis and the AMT basis of the stock. This occurs because the AMT income recognized due to the exercise of the ISOs in the year of exercise is added to the stock's basis for AMT purposes, but not for regular tax purposes. If the price of the stock at the time of the disposition is greater than or equal to the price of the stock at the time the ISOs were exercised, the adjustment will be a negative adjustment for the same amount as the original positive AMT ISO adjustment. The taxpayer will receive long-term capital gain or loss treatment on the disposal.

Disqualifying disposition: If the ISO stock is disposed of in a disqualifying disposition (i.e., before the holding requirements for a qualifying disposition in Sec. 422 are met), the ISO rules do not apply, and the amount includible in income is determined under Sec. 83(a). Thus, the income attributable to the exercise of the option (the FMV of the stock at the time it is substantially vested less the exercise price) is treated by the option holder as ordinary compensation income for regular tax purposes in the tax year the disqualifying disposition occurs. However, if the disqualifying disposition of the stock is a sale or exchange for a price less than the price of the stock at exercise, the amount that is includible as compensation attributable to the exercise of the option is limited to the excess (if any) of the amount realized on the sale or exchange over the adjusted basis of the stock.

If the disqualifying disposition occurs in the same year as the exercise, the tax treatment is similar to that for an NQSO, with the bargain element in the stock at the time of exercise being ordinary income for the option holder in the year of exercise for both regular tax and AMT purposes, so that no AMT adjustment is necessary in that year. If the stock is disposed of in a disqualifying disposition for an amount greater than the FMV of the stock at exercise, the character of the amount of gain is determined under the Sec. 302 redemption rules.

AMT considerations and planning opportunities

As a result of the law known as the Tax Cuts and Jobs Act, P.L. 115-97, fewer individuals are now subject to the AMT. Between the limitation and removal of typical itemized deductions that have caused taxpayers to be subject to the AMT, plus an increase in the AMT exemption amount, an environment has been created where many individuals who have historically been subject to the AMT will no longer find themselves in that situation. Individuals with high ordinary income, such as wages, could be even further immunized from the AMT regime.

On the surface, a taxpayer's being subject to the AMT in the year of exercise seemingly thwarts the strategy behind owning ISOs. This situation somewhat hinders the option holder's enjoyment of the coveted ISO benefits. It is important to remember that all is not necessarily lost if clients find themselves subject to the AMT during the year of exercise due to the AMT credit, which is explored further below. The following are some planning options associated with ISOs:

Exercise and sell (disqualifying disposition)

Exercising and immediately selling will trigger a disqualifying disposition. The ISOs will mostly revert to NQSOs in terms of their tax treatment. Similar to the strategy discussed in the NQSO section, this strategy may appeal to those clients looking to limit their cash outlay or exposure to a concentrated position in company stock.

Exercise and hold (qualifying disposition)

The options are exercised and the shares are sold more than two years after the grant date and more than one year after exercise. The tax results of a qualifying disposition are described above. As noted, in this scenario, appreciation in the value of the stock above the exercise price will be taxed at long-term capital gains rates.Intentional disqualifyingdisposition

Prior to the dot-com bubble of the late 1990s, many individuals in the tech industry exercised highly valued ISOs, incurring a large AMT liability on top of the price paid to exercise options. After the market crash and subsequent rapid devaluation of their position, some were left holding stock worth significantly less than the price they paid to acquire it and were unable to pay the AMT incurred due to the exercise of the ISOs. A method to potentially avoid a disaster like this would be to exercise early in the year, or some other time that is deemed advantageous, and track the stock value throughout the year. If the value greatly depreciates, the stock can be sold before year end. This would intentionally trigger a disqualifying disposition, thus avoiding the positive AMT adjustment and any accompanying AMT tax liability.

Exercise and sell to cover taxes

This is a mix of the exercise-and-sell and the exercise-and-hold strategies. Like the strategy discussed in the NQSO planning section, this can be used to improve cash flow during the exercise event. The immediate sale of the shares to cover the AMT is a disqualifying disposition. The remaining shares received can be held for future appreciation and, if the holding period requirements are met, favorable qualifying disposition treatment.

Swap

If an individual already owns shares of company stock and wants to limit the cash outlay on the exercise of ISOs, a swap could be of value. In this strategy, he or she can perform a swap of currently owned shares (at their FMV) to exercise the ISOs. The existing shares will be exchanged with the issuing company for the new ISO shares. It is important to note that the swap itself is tax-free, but not necessarily the exercise, as this could generate an AMT liability. Consideration should be given for special situations, such as if the shares being swapped in are ISO shares themselves. The company's stock plan must allow for swapping.

AMT credit

When taxpayers find themselves subject to the AMT as a result of the exercise of ISOs, all or part of the AMT paid will generate a credit to be used against regular tax in future years. This credit can be used to offset regular tax in years where the regular taxable income exceeds the AMT income (AMTI). Often, the principal event that will unlock use of this credit is when the ISO shares are ultimately sold. The regular tax stock basis is lower due to the absence of any income inclusion at exercise. This difference in basis for regular tax versus AMT purposes generally causes the regular-tax income to be higher than AMTI as a result of the sale. While paying AMT upfront may appear to be a loss, in many cases it will be a "timing" issue that balances out in the future.

Focusing on value

At times for CPAs, it is easy to focus narrowly on obtaining the best tax result possible. It is important to take a step back and remember that the most favorable tax result is not always the best overall financial result for the client. Any stock option planning should be done as part of a comprehensive financial plan. It is crucial for CPAs to be proactive in gathering information from clients to provide timely and prudent advice. Whether it is a routine situation, or something more nuanced, such as planning ahead of a possible merger or acquisition, the goal should be to maximize the value that clients receive from their option exercise and sale events. The various strategies discussed in this column represent many viable options to tackle a wide array of interpretations of the word "value."

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