Stock Options and Restricted Stock

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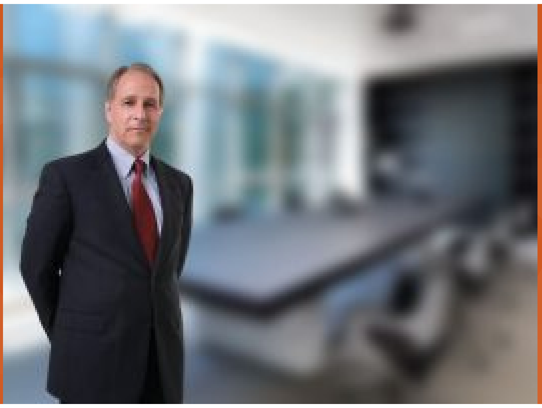

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I. Introduction.

Equity compensation awards by privately owned corporations are typically structured as either grants of stock options or issuances of restricted stock. In general, the goal of the award recipient is to defer his or her obligation to pay the purchase price and tax costs of the award for as long as possible and to maximize the portion of his or her income from the award that is taxable at long-term capital gain rates.[1] Stock options can be attractive to the recipient because, within specified parameters, they allow the recipient to decide in the future whether and when to pay the purchase price for the award. Often, however, the recipient of a stock option reports most or all of his or her income at ordinary income rates, or at least has to pay tax upon exercising the option, even if the option is issued as a supposedly tax-favored "incentive stock option" (or "ISO"). The infirmities in the option rules sometimes cause the parties to equity compensation transactions to consider the use of restricted stock as an alternative. This article reviews and compares the tax aspects of compensatory stock option grants and restricted stock awards by corporations.

II. Options.

Generally speaking, there are two types of compensatory options. One type of compensatory option is the ISO.[2] The other is the option that is not an ISO (often referred to as a "non-qualified stock option" or "NQO").[3] Because ISOs are best understood in comparison to NQOs, this article will consider NQOs first.

a. NQOs.[4]

1. Treatment of grantee. The grantee of a NQO generally reports ordinary compensation income upon exercising the NQO in an amount equal to the excess of (i) the fair market value, as of the time of exercise, of the stock received upon exercising the NQO over (ii) the exercise price of the NQO (the excess of the fair market value of the stock underlying an option over the exercise price of the option is sometimes referred to as the "spread").[5] The grantee then receives the underlying stock with a fair market value basis and a holding period beginning on the date of exercise.[6] Thus, the grantee of a NQO generally reports the pre-exercise appreciation in the value of the underlying stock as ordinary income upon the exercise of the NQO and the post-exercise appreciation in the value of the underlying stock as capital gain (long-term if he or she holds the stock for more than a year after exercising) upon the disposition of the stock.

2. Treatment of corporation. Subject to any applicable deductibility limitations, the corporation granting the NQO has a compensation deduction that mirrors the

compensation income of the grantee in both amount and timing. The corporation may be required to properly report the grantee's compensation income on a Form W-2 or 1099, as the case may be, as a condition to taking the deduction. The corporation must also withhold and pay employment tax with respect to the grantee's compensation income if the grantee is an employee.

b. ISOs.

1. Qualification requirements.

A. *In general*. An option may qualify as an ISO only if:

(i) it is granted pursuant to a written (or electronic) plan that (x) specifies the maximum aggregate number of shares that may be issued under the plan through ISOs and the employees (or class or classes of employees) eligible to receive grants, and (y) is approved by the stockholders of the granting corporation within twelve months before or after the date on which the plan is adopted;

(ii) it is granted within ten years after the earlier of the date of the adoption of the plan or the date of the approval of the plan by the granting corporation's stockholders;

(iii) it is not exercisable more than ten (or, if the grantee is a 10% stockholder, five) years after its grant date;

(iv) the exercise price of the option is not less than the fair market value (or, if the grantee is a 10% stockholder, 110% of the fair market value) of the underlying stock as of the grant date;

(v) the option is not transferable by the grantee other than by will or the laws of descent and distribution and is exercisable during the grantee's lifetime only by the grantee; and

(vi) the grantee is an employee of either the granting corporation, a parent or subsidiary corporation of such corporation, or a corporation (or parent or subsidiary of such corporation) substituting or assuming the stock option as a result of a corporate reorganization, from the date of the grant of the option until the date three months (or one year in the case of the grantee's death or disability) before the exercise of the option.

B. *$100,000 limitation*. In addition, an option will not qualify as an ISO to the extent that the underlying stock with respect to which the option is exercisable for the first time during any calendar year has a value exceeding $100,000 as of the grant date. For example, if an employee is granted an option to acquire stock worth $500,000 on the grant date and the option is immediately exercisable, only 20% of the option ($100,000/$500,000) may qualify as an ISO. If the option becomes exercisable as to only 20% of the underlying shares per year over five years, the option may qualify as an ISO in its entirety.

C. *Other conditions*. The exercisability of an ISO may be made subject to conditions (including vesting conditions) that are "not inconsistent" with the rules described immediately above.

2. Treatment of grantee.

A. *In general*. Under the general ISO rules, the grantee of an ISO is not taxed upon exercising the ISO. Instead, upon his or her disposition of the underlying stock, the grantee reports the amount he or she receives in the disposition less the exercise price of the ISO as long-term capital gain. Thus, and in contrast to the NQO rules (which, again, tax the pre-exercise appreciation as ordinary income upon the exercise of the option and the post-exercise appreciation as capital gain upon the disposition of the underlying stock), the general ISO rules tax both the pre-exercise and post-exercise appreciation as long-term capital gain upon the disposition of the underlying stock.[7]

B. *Caveats*. Unfortunately, the general ISO rules have two significant caveats that often serve to defeat the tax objectives of ISO awards.

(i) Disqualifying dispositions. The first caveat is that the grantee must hold the underlying stock for at least two years after the grant of the ISO and at least one year after the transfer of the stock to the grantee upon his or her exercise of the ISO. A disposition of the underlying stock before these holding periods have run (referred to as a "disqualifying disposition") requires the grantee to report the spread on the option at the time of exercise (or, if less, the excess of the disposition price over the exercise price) as ordinary compensation income for the year of the disposition. Any amount by which the disposition price exceeds the value of the stock at the time of the exercise of the option is generally taxable as capital gain for the year of the disposition.[8] If the disposition price of the stock is less than the exercise price of the option, the grantee has no income from the disqualifying disposition but instead reports a capital loss equal to the excess of the exercise price over the disposition price.

(ii) AMT. The second caveat is that the alternative minimum tax (or "AMT") rules accord no special treatment to ISOs. Thus, the grantee must include the spread on the ISO at the time of exercise in computing his or her alternative minimum taxable income for the year of exercise (unless he or she disposes of the stock in the same year as the exercise).[9] Depending on the size of the spread and the grantee's other adjustments and preferences, the AMT rules can subject the grantee to tax for the year of exercise at the AMT rate on some portion of the spread at the time of exercise.

C. *Preferable to grantee*. Despite the caveats, employees generally prefer ISOs to NQOs. Again, the exercise of a NQO generally requires the grantee to report the spread upon exercise as ordinary compensation income for the year of exercise. The exercise of an ISO not followed by a disqualifying disposition is generally a tax event only for purposes of the AMT. Any AMT payable as a result of the exercise of an ISO is likely to be less than the regular tax liability resulting from the exercise of a NQO with the same spread because of the lower AMT rates and the way the AMT is calculated. If the employee makes a disqualifying disposition, he or she must report the spread upon exercise as ordinary compensation income (i) for the year of the disposition rather for the year of the exercise and (ii) net of any amount by which the disposition price is less than the value of the stock as of the time of exercise (if the option were a NQO, any such recognized post-exercise depreciation would likely have been a capital loss rather than an offset against ordinary compensation income).[10]

3. Treatment of corporation. A corporation that grants an ISO reports no compensation deduction with respect to the ISO unless the grantee makes a disqualifying disposition. Upon a disqualifying disposition, the corporation deducts the compensation income reported by the grantee subject to any applicable deductibility limitations and the compliance by the corporation with applicable reporting rules.

c. Vesting.

Typically, options vest over time. It is possible, however, for options to vest as performance goals are met.[11] In any event, in the case of an option, "vesting" generally establishes the right of the grantee to exercise the option (to the extent the option has vested) and thereby purchase the underlying stock at a price fixed on the grant date. If the corporation retains any right to repurchase stock purchased by the grantee by exercising the option, the repurchase price is typically the fair market value of the stock at the time of the repurchase (or some formula price intended to approximate fair market value).[12] The vesting of the option generally has no tax consequence to the grantee or to the corporation.[13]

III. Restricted Stock

Rather than grant an option to a service provider, a corporation could simply issue stock to the service provider at the outset. In that case, the tax consequences to the service provider and the corporation depend on whether or not the stock is "substantially nonvested" upon its issuance and, if the stock is "substantially nonvested," whether or not the service provider makes an election under Section 83(b) (a "Section 83(b) election") with respect to the stock.

a. "Restricted stock;" "substantially nonvested."

As used in this article, the term "restricted stock" means stock that the corporation issues at the outset to a service provider and that is "substantially nonvested." Stock is "substantially nonvested" for as long it is both subject to a "substantial risk of forfeiture" and "non-transferable." Stock is subject to a "substantial risk of forfeiture" for as long as it is subject to repurchase at a price less than its fair market value (typically, the service provider's cost) if the service provider ceases to perform substantial services (or if there is otherwise a failure of a condition related to a purpose of the transfer).[14] Stock is non-transferable for as long as it may not be transferred free of a substantial risk of forfeiture.

b. Vesting.

Restricted stock can be made subject to the same time or performance based vesting conditions as might apply to options (and can also be made subject to repurchase by one or more of the other shareholders in addition to or instead of the corporation). In the case of restricted stock, "vesting" generally terminates the obligation of the recipient to sell the stock back to the corporation at a price that is less than fair market value.[15] Thus, as to both options and restricted stock, "vesting" establishes the right of the service provider to receive any value of the stock in excess of the price established at the outset. The difference between the two approaches is that, under a restricted stock arrangement, the stock is actually issued to the service provider up front subject to a right of the corporation to repurchase any unvested portion of the stock at a price less than fair market value (again, typically the service provider's cost).

c. Receipt of vested stock.

If a service provider receives stock that is vested (i.e., that is not "substantially nonvested") at the outset, he or she reports any excess of the then value of the stock over the amount he or she pays for the stock as ordinary compensation income.

d. Receipt of restricted stock.

If a service provider receives restricted stock, his or her tax consequences depend on whether or not he or she makes a Section 83(b) election with respect to the stock.

1. <u>No Section 83(b) election</u>. If the recipient does not make a Section 83(b) election with respect to the stock, he or she reports no compensation income with respect to the stock until the stock vests. Whenever any of the stock vests, he or she reports ordinary compensation income equal to the excess of the value of the vesting stock at the time it

vests over the amount he or she paid for that stock (so that vesting is the compensation event, and the appreciation in the value of the vesting stock between the time of its issuance and the time of its vesting is ordinary income at the time of its vesting).[16] The fair market value of the vesting stock becomes the recipient's basis in that stock, and his or her holding period in the vesting stock begins, at the time of vesting.

2. Section 83(b) election. If the recipient makes a Section 83(b) election with respect to the stock, then, upon his or her receipt of the stock, he or she reports any excess of the then value of the stock (without regard to the service related restrictions) over the amount he or she pays for the stock as ordinary compensation income (receipt being the compensation event for tax purposes).[17] He or she takes a fair market value basis in the stock, and his or her holding period begins, upon his or her receipt of the stock. The recipient then suffers no tax consequences upon vesting. Instead, he or she reports capital gain upon selling the stock equal to the amount he or she receives in the sale less his or her basis in the stock (so that all of the post-issuance appreciation is capital gain upon the disposition of the stock). If he or she forfeits the stock by failing to vest, however, his or her loss (which is generally a capital loss) is limited to the excess, if any, of the amount he or she paid for the stock over the amount he or she receives upon forfeiting the stock (thus, he or she is not entitled to recoup any income he or she reported upon receiving the stock by taking a corresponding deduction upon forfeiture).[18]

3. Election considerations. In deciding whether or not to make a Section 83(b) election, a recipient of restricted stock must weigh (i) the cost of making the election (any tax he or she must pay upon receiving the stock as a result of the stock's value at issuance exceeding the amount he or she pays for the stock, without the benefit of any corresponding loss if he or she later forfeits the stock) against (ii) the benefits of making the election (establishing his or her tax basis, beginning his or her holding period and nullifying the tax consequences of vesting so that any subsequent appreciation in value is taxed as capital gain when he or she sells the stock).[19]

4. Tax ownership of stock. If the recipient does not make a Section 83(b) election, he or she is not deemed to own the stock for tax purposes until the stock vests, and any distributions made to the recipient with respect to the stock before vesting are treated as compensation payments.[20] If the corporation is an S corporation, the recipient does not report any of the corporation's taxable income or loss as a shareholder. It is not unusual for S corporations to require that recipients of restricted stock make Section 83(b) elections.

5. Making the election. To be effective, a Section 83(b) election must be filed with the Internal Revenue Service ("IRS") by the recipient within thirty days after his or her receipt of the stock. The recipient must also provide the corporation (and others in certain instances) with a copy of the election.

e. Treatment of corporation.

Subject to any applicable limitations and the compliance with applicable reporting rules, the corporation's compensation deductions mirror the recipient's compensation income in both amount and timing.

IV. Practical Considerations.

A number of practical considerations may factor into structuring equity compensation awards.

a. Stock value.

A key factor in determining whether to grant an option or issue restricted stock to a service provider is often the value of the underlying stock at the time of the award. Because stock value determines the up-front cost (in terms of purchase price and/or tax) of a restricted stock award coupled with a Section 83(b) election, a low stock value generally facilitates restricted stock awards.[21] If the value of the stock is high at the time the award is to be made, however, the up-front cost of a restricted stock award may cast the option alternative in a more favorable light.[22]

b. Payment terms.

The parties may desire to minimize the service provider's up-front cost of a restricted stock award coupled with a Section 83(b) election by having the service provider purchase the stock with a note. If the service provider is personally liable for the amount due under the note, the note should be included in the amount paid by the service provider for the stock. If the service provider is not personally liable for a "substantial portion" of the amount due under the note, however, the IRS may attempt to treat the service provider as having only a NQO.[23] Any principal on the note that is forgiven is likely to be ordinary compensation income to the service provider when forgiven (and not eligible for the "purchase price adjustment" exception of Section 108(e)(5) of the Code on account of its being in the nature of compensation income rather than income from the cancellation of indebtedness). Arrangements that obligate the corporation to repurchase the stock in ways that minimize the service provider's risk with respect to the stock can undermine the tax objectives sought in using restricted stock.

c. Complexity.

Restricted stock awards can be more complicated than option awards. It is not unusual for corporations to limit restricted stock awards to only certain employees.

d. Stock outstanding.

Often, restricted stock is issued to a service provider solely to accommodate the service provider's tax objectives. If not for the tax laws, the corporation would have granted options to the service provider to condition the service provider's right to hold shares on the satisfaction of vesting requirements. For state law purposes, however, the service provider is a shareholder despite the fact that he or she might not yet have fully "earned" the shares held by him or her. Issues may arise as to the extent to which the service provider is to have voting and other rights with respect to unvested shares.

V. New Code Section 83(i).

The Tax Cuts and Jobs Act of 2017 added Section 83(i) to the Code. Under Section 83(i), a "qualified employee" who receives "qualified stock" upon the exercise of an option (or settlement of a restricted stock unit) may elect to defer (for income but not employment tax purposes) including the income that he or she would otherwise have been required to include for the year in which he or she receives the stock (or, if later, the first year for which the stock ceases to be "substantially nonvested") until the earliest of (i) the date on which the stock first becomes transferable, (ii) the date on which he or she first becomes an "excluded employee," (iii) the date on which any stock of the issuing corporation first becomes readily tradable on an established securities market, (iv) the date five years after the date on which the stock first ceased to be "substantially nonvested," or (v) the date as of which he or she revokes the deferral election.[24]

a. Qualified employee.

A "qualified employee" is any employee who is not an "excluded employee" (and who agrees in his or her deferral election to be subject to certain requirements related to the corporation's withholding obligations).

b. Excluded employee.

An "excluded employee" is any individual who (i) is (or has been during the ten preceding calendar years) a 1%-owner, (ii) is (or has been) the corporation's chief executive officer or chief financial officer (or an individual acting in a similar capacity), (iii) is a family member (as defined in Code Section 318(a)(1)) of an individual described in (ii), or (iv) is (or has been during the ten preceding calendar years) one of the four most highly compensated officers of the corporation.

c. Qualified stock.

"Qualified stock" is stock received by a "qualified employee" upon the exercise of an option (or settlement of a restricted stock unit) granted to him or her in connection with his or her performance of services as an employee of the issuing corporation during a calendar year in which the corporation was an "eligible corporation" (excluding stock that he or she may sell back to the corporation when it ceases to be "substantially nonvested").

d. Eligible corporation.

A corporation is an "eligible corporation" for any calendar year if (i) no stock of such corporation (or a predecessor) was readily tradable on an established securities market during any preceding calendar year and (ii) the corporation has a written plan under which, in such calendar year, at least 80% of all employees who provide services to the corporation in the United States (or any United States possession) are granted stock options (or restricted stock units) with the "same rights and privileges" to receive qualified stock. Employees can receive different numbers of shares so long as the number of shares available to each employee is more than a de minimis amount.

e. Coordination with ISO rules.

The making of a deferral election under Section 83(i) with respect to stock acquired by exercising an option would cause the option not to be an ISO.

f. Coordination with Section 409A.

The deferral provided by Section 83(i) does not cause the applicability of Section 409A.

Footnotes.

1. Currently, the maximum federal rates applicable to ordinary income and most long-term capital gains (and dividends from domestic corporations) of individuals are 37% and 20%, respectively. In addition, an individual with "modified adjusted gross income" exceeding a threshold ($200,000 or, if the individual is married filing jointly, $250,000) is subject to a 3.8% tax under Code Section 1411 on the lesser of (i) his or her "net investment income" or (ii) the amount of his or her "modified adjusted gross income" in excess of the threshold. Net investment income includes, net of "properly allocable deductions," (a) interest, dividends, annuities, royalties and rents (with an exception for such income derived from non-passive activities), (b) income from passive activities, and (c) gains from dispositions of property (with exceptions for gains from dispositions of property held, and of interests, in non-passive activities).

2. The ISO rules are set forth in Sections 421 through 424 of the Internal Revenue Code (the "Code") and the Income Tax Regulations (the "Regulations") thereunder.

3. The NQO rules are set forth in Section 83 of the Code and the Regulations thereunder. The NQOs discussed in this article are presumed not to have readily ascertainable fair market values, within the meaning of the Regulations under Section 83 of the Code, when granted.

4. Under Section 409A of the Code, the grantee of a NQO can, absent an exemption of the NQO from that Section, be subject to tax and a 20% penalty as the NQO vests and thereafter as the underlying equity appreciates. The NQOs discussed in this article are presumed to be granted

with respect to "service recipient stock" and without any "additional feature of deferral" (both terms as defined in Section 409A) and at exercise prices at least equal to the fair market values of the shares underlying them on their grant dates (and are therefore presumed to be exempt from Section 409A).

5. See, however, "New Code Section 83(i)" in V. below.

6. If the stock received upon exercising the NQO is "substantially nonvested" (see discussion of restricted stock below), however, the grantee is deemed to exercise the NQO when or as the stock ceases to be substantially nonvested unless he or she makes a Section 83(b) election with respect to the stock (in which case the restriction is disregarded and the exercise of the NQO is the relevant tax event).

7. If the stock received upon exercising the ISO is "substantially nonvested" (see discussion of restricted stock below), the grantee apparently may not make a Section 83(b) election with respect to the stock (except for purposes of the alternative minimum tax). See Code Section 83(e)(1) and Regulations Section 1.422-1(b)(3), Example 2.

8. Under the Regulations, if the stock received upon exercising the ISO is "substantially nonvested" (see discussion of restricted stock below), the periods of time for which the grantee must hold the stock to avoid a disqualifying disposition apparently run from the dates of grant and transfer as they would have if the stock had not been subject to vesting. The consequences of a disqualifying disposition, however, are determined under Section 83(a). See Regulations Section 1.421-2(b)(1) and Section 1.422-1(b)(3), Example 2. Thus, under the Regulations, the amounts of ordinary compensation income and capital gain reportable upon a disqualifying disposition by the grantee of stock that was received subject to vesting are determined with reference to the value of the stock at the time of vesting rather than at the time of the exercise of the option (without the ability of the grantee to make a Section 83(b) election). The portions of the Regulations under Sections 421 and 422 applicable to unvested stock are difficult to comprehend.

9. The maximum AMT rate applicable to individuals is 28%. Again, if the stock received upon exercising the ISO is "substantially nonvested," the grantee may make a Section 83(b) election for purposes of the AMT.

10. ISOs are also not subject to the provisions of Section 409A. Of course, ISOs have their own exercise price requirement, which, as a practical matter, may require the same type of valuation required to ensure that NQOs are not subject to Section 409A.

11. It can be a good idea to involve the corporation's accountants in the implementation of a plan to avoid unintended effects on the corporation's financial reporting.

12. It is possible to structure arrangements in which service providers are granted options to purchase shares that are subject to vesting. An extensive discussion of these types of arrangements, particularly arrangements where ISOs are exercisable for restricted stock, is beyond the scope of this article.

13. Vesting can have tax consequences, however, if the option is subject to Section 409A.

14. For stock to be substantially nonvested, the possibility of forfeiture must be substantial if the condition is not satisfied. As an example, Section 1.83-3(c)(2) of the Regulations provides that stock is not subject to a substantial risk of forfeiture if it may be repurchased at less than fair market value only if the service provider is terminated for cause or for committing a crime.

15. Technically, vesting occurs when the stock becomes either (i) no longer subject to a substantial risk of forfeiture or (ii) transferable (free of a substantial risk of forfeiture).

16. The fair market value is determined taking into account only restrictions which by their terms will never lapse (referred to as "nonlapse restrictions"). An example of a nonlapse restriction is an obligation to sell the stock at a formula price under a buy-sell agreement.

17. The fair market value is determined taking into account only nonlapse restrictions.

18. The consequences of the forfeiture rule may be even more significant if the corporation is an S corporation and the recipient has had to report a share of the corporation's income without receiving a corresponding tax distribution.

19. That the amount payable by the service provider for the stock is the stock's fair market value upon issuance does not negate the applicability of the Section 83 rules or the need to file a Section 83(b) election to nullify the consequences of vesting. See Alves v. Commissioner, 54 AFTR 2d 84-5281, 734 F.2d 478 (9th Cir. 1984). Thus, a Section 83(b) election is especially in order if the service provider is paying fair market value for restricted stock.

20. Absent a Section 83(b) election, the shares are not treated as being outstanding for S corporation qualification purposes until they have vested.

21. Unlike options, restricted stock awards need not be issued at fair market value to avoid Section 409A. With a restricted stock award, the compensation event happens at issuance or vesting (depending on whether or not a Section 83(b) election is made) without the imposition of a Section 409A 20% penalty.

22. An option would have to have a fair market value exercise price (to qualify as an ISO and/or avoid Section 409A), but the service provider would have no risk with respect to the stock until he or she were to exercise the option.

23. See Regulations Section 1.83-3(a)(2).

24. A "restricted stock unit" is a contractual right to receive a specified number of shares (or the cash value of the shares) upon vesting. Generally, absent an election under Section 83(i), the recipient is taxable upon the receipt of the shares.