Take Stock

A look at how options are taxed.

BY **ROBERT W. WOOD**

If your client or company offers you stock options or restricted stock, listen up. There are tax opportunities and there are traps. There are two types of stock options, incentive stock options, or ISOs, and non-qualified stock options, or NSOs. Your plan and option grant should tell you which.

ISOs are taxed the most favorably. There is generally no tax at the time they are granted and no "regular" tax at the time they are exercised. Thereafter, when you sell your shares, you will pay tax, hopefully as a long-term capital gain. The usual capital gain holding period is one year, but to get capital gain treatment for shares acquired via ISOs, you must: (a) hold the shares for more than a year, and (b) sell the shares at least two years after your ISOs were granted.

When you exercise an ISO, you pay no "regular" tax, but there could be alternative minimum tax, or AMT.

Example: You receive ISOs to buy 100 shares at the current market price of $10 per share. Two years later, when shares are worth $20, you exercise, paying $10. The $10 spread is subject to AMT. How much AMT you pay depends on your other income and deductions, but it could be a flat 28 percent AMT rate on the $10 (28 percent x $10 = $2.80).

NSOs are more common. With NSOs, there is no tax when the option is granted. When you exercise, though, you have ordinary income (and, if you are an employee, employment taxes). When you exercise, you are taxed on the difference between what you pay and the value of the stock you buy.

Example: You receive an option to buy stock at $5 per share when the stock is trading at $5. Two years later, you exercise when the stock is trading at $10 per share. You pay $5 when you exercise, but the value at that time is $10, so you have $5 of compensation income. If you hold the stock for more than a year and sell it, any sales price above $10 should be long-term capital gain.

What if you receive restricted stock instead of options? If there are conditions attached (say, you must stay for two years to get it or to keep it), restricted property rules apply (Section 83 of the tax code).

Example: If you remain with your company for 36 months, you will be awarded $50,000 worth of stock. You don't "pay" anything for the stock, but it is given to you in connection with your services. You have no taxes until you receive the stock. The IRS waits 36 months to see what will happen. When you receive the stock, though, you have income (the value of the stock at that time), which is treated as wages.

With restrictions that will lapse with time, the IRS waits to see before taxing it. But with "non-lapse" restrictions that will never expire, the IRS values the property subject to those restrictions.

Example: Your employer promises you stock if you remain with the company for 18 months. But when you receive the stock, it will be subject to permanent restrictions under a company buy/sell agreement requiring you to resell the shares for $20 per share if you ever leave the company. The IRS will wait and see (no tax) for the first 18 months. At that point, you will be taxed on the value, probably $20 given the resale restriction.

In some cases, you can *elect* to include the value in your income earlier (in effect disregarding the restrictions). The goal is to try to include it in income at a low value, to lock in future capital gain treatment. To elect current taxation, you must file a written 83(b) election with the IRS within 30 days of receiving the property. You must report the value of what you received as compensation (which might be small or even zero).

Example: You are offered stock by your employer at $5 per share when the shares are worth $5, but you must remain with the company for two years to be able to sell them. You already have paid fair market value for the shares. That means filing an 83(b) election could report *zero* income. Yet by filing it, you convert what would be ordinary income property into capital gain. When you sell the shares more than a year later, you'll be glad you filed the election.

Enjoy your options or your stock, but do some planning and get some advice. Sometimes, big tax differences can hang in the balance. **TBJ**

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