INCENTIVE STOCK OPTIONS, NONQUALIFIED STOCK OPTIONS AND CASH COMPENSATION PROGRAMS

This bulletin reviews the federal income tax differences among incentive stock options ("**ISO**s"), nonqualified (or "nonstatutory") stock options ("**NQSO**s") and cash compensation programs to an employer and employee and analyzes the viability of each after current tax law.

Under the Internal Revenue Code, ISOs can be issued only to employees of corporations. In contrast, NQSOs can be issued to employees, independent contractors (such as consultants or underwriters) or members of the board of directors and can be issued by limited liability companies and partnerships.[1]

Requirements for ISOs

An option must satisfy a number of special tax law requirements to qualify as an ISO, but an NQSO does not have to satisfy these requirements. The principal requirements are:

- The exercise price of an ISO must be set at no less than the fair market value of the stock on the date the option is granted to the employee (110% of the fair market value if the employee owns more than 10% of

[1] State income tax consequences are not addressed in this bulletin. Generally, the California income tax consequences are similar to the federal income tax consequences. An important exception is that California does not have a preferential tax rate for net long-term capital gain.

the outstanding stock on that date); in contrast, the exercise price of a NQSO is not restricted by tax law.[2]

- The ISO plan must set forth the maximum aggregate number of shares for which ISOs may be granted and the class of employees who may receive ISOs, and the plan must be approved by the shareholders within 12 months before or after the plan is adopted by the Board of Directors.
- The ISO plan must expire no more than ten years after it is adopted.
- Each ISO must expire not more than ten years from the date of grant (five years for holders of 10% or more of the outstanding stock on the date of grant).
- The employee must exercise the ISO while employed by the granting corporation or a corporation that was a parent or subsidiary of the granting corporation (either directly or indirectly) on the date of grant. The employee can also exercise within three months after termination of such employment, if permitted by the ISO plan and agreement. The ISO plan or agreement can allow an extended exercise period if the ISO holder dies or is disabled.
- In any year no more than $100,000 of stock (valued at the date of grant) can first become exercisable by an employee under all ISOs of the employer and its affiliates. The excess stock is treated as acquired under an NQSO.
- The ISO is treated as cancelled and granted again if it is modified in a way that benefits the employee (other than by making the option exercis-

[2] State securities law rules, if they apply to the grant, might require the exercise price under an NQSO to be at least equal to 85% of the market value of the shares on the date of grant. Also, an exercise price of less than the fair market value on the date off grant (or other deferred compensation features) can cause the option arrangement to become subject to Section 409A and its onerous penalties.

able earlier). In that event, the exercise price must be the fair market value on the new date of grant (which would be the date of the modification) and the holding period requirements (discussed at 3.1 below) would run from the new grant date.

- In an acquisition or reorganization, another company can substitute its options for the seller's ISOs; no modification will occur if the benefit to the employee is not increased (as determined under a formula set forth in the Treasury Regulations).

Comparison of Tax Consequences

The tax consequences of ISOs and NQSOs involve four key dates: (1) when the option is granted to the employee; (2) when the employee exercises the option and acquires the stock; (3) when temporary restrictions (if any) on the stock lapse; and (4) when the employee sells or otherwise disposes of the stock in a taxable transaction.

1. When the Option is Granted

The grant of an ISO does not result in current taxable income to the employee or a current tax deduction for the employer.

Similarly, the grant of a NQSO does not result in current taxable income to the employee or a deduction for the employer (unless the option is actively traded on an established market, which would be unusual).

2. When the Option is Exercised

2.1 ISOs

Upon the exercise of an ISO, the employee does not recognize any income for regular tax purposes and the employer is not allowed a deduction.

The excess of the fair market value of the stock on the exercise date over the exercise price (the "spread") is an item of adjustment for the employee for purposes of the federal alternative minimum tax (the "**AMT**"). Many people exercised ISOs in early 2000 and generated substantial AMT, only to find in early

2001 that their shares were not worth as much as the AMT that was due then. Congress was not sympathetic. To avoid this serious tax problem, employees who exercise ISOs and hold their shares should consider selling the shares during the year of exercise,[3] even though this will eliminate the ISO tax benefits.

The employee's tax basis in the stock for regular tax purposes is equal to the exercise price, and for AMT purposes is equal to the fair market value of the stock on the exercise date.

At exercise of an ISO the spread is not subject to FICA taxes or federal income tax withholding.[4] The disposition of the shares, even a disqualifying disposition, is not subject to FICA taxes or federal income tax withholding.[5] These rules were part of the 2004 Jobs Creation Act and resolved IRS flip-flops on the subject.

Example. If the fair market value of the stock upon exercise is $100 per share, and the exercise price is $40 per share, then the $60 spread is not taxable to the employee upon exercise and the employer is not allowed a deduction. The $60 spread, however, is an adjustment item for the employee' alternative minimum tax calculation. The employee's tax basis for regular tax purposes is $40 per share, and is $100 per share for alternative minimum tax purposes.

2.2 NQSOs

The tax consequences upon exercise of a NQSO depend on whether the stock is subject to a substantial risk of forfeiture ("**SROF**") within the meaning of

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[3] Calendar it for December in the year of exercise.

[4] I.R.C. §§ 3121(a)(22)(A), 3306(b)(19)(A).

[5] I.R.C. §§ 421(b), 3121(a)(22)(B), 3306(b)(19)(B). The disposition could require the employee to pay estimated taxes, however. The employer probably must report the income from the disqualifying disposition on the employee's Form W-2, so plans should continue to require the employee to notify the employer of a disqualifying disposition of the shares.

Section 83 of the Internal Revenue Code. Generally, options are subject to exercise schedules, but not also to substantial risks of forfeiture.

2.2(a) **No SROF**

If the stock is not subject to a SROF, the employee recognizes ordinary income in the year of exercise in an amount equal to excess of the fair market value of the stock on the exercise date over the exercise price. The ordinary income may be taxed at the maximum federal income tax rate of 38.6%. The spread at exercise is wages subject to FICA and Medicare taxes.[6]

The employee's tax basis in the stock equals the fair market value of the stock on the exercise date.

The employer is allowed a deduction in an amount equal to the income to the employee.[7] If the employer is a C corporation in the maximum tax bracket, the deduction will shelter income otherwise taxed at a maximum rate of 35%.

Example. If the fair market value of the stock upon exercise is $100 per share, and the exercise price is $40 per share, then the $60 spread is taxable to the employee upon exercise and the employer is allowed a deduction in the same amount. The employee's tax basis is $100 per share for both regular and AMT purposes. The employee does not have an AMT adjustment.

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[6] Rev. Rul. 78-185, 1978-1 C.B. 304.

[7] The deduction is allowable for the taxable year of the employer in which ends the employee's taxable year in which the income is includible. The employer's deduction is not allowed unless applicable income tax reporting requirements are satisfied. Income tax withholding has not been a requirement for the employer's deduction since the IRS issued revised regulations in 1995. Treas. Reg. § 1.83-6(a), *revised by* T.D. 8599 (July 19, 1995).

2.2(a) **SROF**

Stock is subject to a SROF if the employee's right to benefit from an increase in the value of the stock is limited by a condition that will "lapse" while the employee owns the stock. For example, a SROF exists if the employee is required to resell the stock to the employer at the lower of the exercise price or the fair market value of the stock if the employee terminates employment within five years after acquiring the stock.[8]

2.2(c) **Subject to SROF/No Section 83(b) Election**

If the stock is subject to a SROF and a Section 83(b) election (discussed below) is *not* made, no income is recognized by the employee until the SROF lapses.

In the year in which the SROF lapses, the employee recognizes ordinary income in an amount equal to the excess of the fair market value of the stock on the lapse date over the exercise price. The employer is entitled to a corresponding deduction, subject to the reporting requirement. The spread at exercise is wages subject to FICA and Medicare taxes.[9]

<u>Example</u>. If the exercise price is $40 per share, the fair market value of the stock is $100 per share at exercise but it is $150 per share when the SROF lapses, and then the $110 spread at lapse is taxable to the employee when the SROF lapses and the employer is allowed a deduction in the same amount at that time. The employee's tax basis is $150 per share for both regular tax and AMT purposes. The employee does not have an AMT adjustment. Because taxation is deferred until the SROF lapses, the $60 spread between the fair market value upon exercise and the exercise price becomes irrelevant.

[8] Other restrictions also may be SROFs. Whether a SROF exists is determined on the particular facts and circumstances; a detailed analysis of the rules is beyond the scope of this bulletin.

[9] Rev. Rul. 79-305, 1979-2 C.B. 350.

Note: The better the business performs, the greater the value of the business -- the more tax the employee must pay at the lapse date. To avoid this counter-incentive, most employers encourage employees to make a "Section 83(b) election."

2.2(d) **Subject to SROF/Section 83(b) Election**

Even if the stock is subject to a SROF on the exercise date, the employee may *elect* to include as ordinary income in the year of exercise the spread (that is, the excess of the fair market value of the stock on the exercise date over the exercise price).[10] The spread at exercise is wages subject to FICA and Medicare taxes.[11] If this "Section 83(b) election" is made, the employer is entitled to a corresponding deduction.

Example. If the fair market value of the stock upon exercise is $100 per share and the exercise price is $40 per share, the employee could make a Section 83(b) election to be taxed on the $60 spread in the year of exercise even though the stock is subject to a SROF. If the election is made, the employer is allowed a deduction in the same amount. The employee's tax basis is $100 per share for both regular and alternative minimum tax purposes. The employee does not have an AMT adjustment. The employee will not be taxed on any additional income when the SROF lapses -- regardless of the value of the stock at that time.

The employee generally *should* consider making a Section 83(b) election if:

(1) The employee does not expect to forfeit the stock;

(2) The employee anticipates substantial appreciation in the value of the stock between the exercise date and the SROF lapse date; *and*

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[10] A discussion of the tax consequences of an eventual forfeiture of stock with respect to which a Section 83(b) election has been made, or a transfer of such stock before the SROF lapses, is beyond the scope of this bulletin.

[11] Rev. Rul. 79-305, 1979-2 C.B. 350.

(3) The employee intends to hold the stock for a substantial period of time after the SROF lapse date.

If all these expectations and intentions are realized, the Section 83(b) election will prevent post-exercise appreciation from being taxed until the employee sells the stock. The employee should also consider the risk that the value of the stock will drop or that he/she will forfeit the stock, in either case triggering a largely useless capital loss. In deciding whether to make a Section 83(b) election, the time value of money should be considered, because tax will be paid at exercise, rather than at lapse -- and some types of SROF might never lapse (example: a restriction that lapses only at an initial public offering of the employer stock, which might never occur). The employee must weigh the value of the deferral of taxes on the post-exercise appreciation against the current tax he/she will pay if the election is made.

3. Sale of Stock

3.1 ISOs

If the employee holds the stock acquired by exercising an ISO for the required ISO holding period (at least *two years after grant* of the ISO and *one year after exercise*), any gain on sale of the stock is characterized as long-term capital gain. The current maximum individual federal income tax rate for long-term capital gain is 20%. The employer is not entitled to any deduction. For AMT purposes, the employee's tax basis in the shares will be higher than his/her regular tax basis, so the AMT gain will be less that the regular tax gain.

If the employee does *not* hold the stock for *both* ISO holding periods, the option is treated as an NQSO, and the gain, if any, from the sale of the stock might include both ordinary income and capital gain: ordinary income to the extent of the excess of the fair market value of the stock on the exercise date over the exercise price, and capital gain for the balance (long-term or short-term depending on whether the stock has been held for more than one year). The employee will not have an AMT adjustment.[12] The employer is entitled to a deduction for the year of the sale equal to the amount of the employee's ordinary income.

Although the IRS proposed that the spread at exercise and the income recognized on a disqualifying disposition would be subject to FICA and Medicare taxes, the IRS has backed off indefinitely from those proposals.[13]

3.2 NQSOs

If the employee sells the NQSO stock after the one-year long-term holding period, the gain will be long-term capital gain. Net long-term capital gain is currently taxed at a maximum federal income rate of 20%. If the long-term holding period is not met, the gain will be short-term capital gain. Net short-term capital gain is currently taxed at a maximum federal income tax rate of 38.6%.

For regular tax purposes, there will be less gain upon sale of NQSO stock than for ISO stock because the tax basis for NQSO stock will be higher than for ISO stock. As discussed above, NQSO stock will have a regular tax basis equal to the *fair market value* of the stock at the time the employee is taxed, whereas ISO stock will have a regular tax basis only equal to the *exercise price*, since the employee is not taxed upon exercise of the ISO.

Both the employee's tax basis in the NQSO stock and his/her gain on the disposition will be the same for regular tax and AMT purposes.

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12 To avoid the AMT adjustment, an employee might consider an early disposition of the shares during the year of exercise.

13 Notice 2002-47, 2002-28 I.R.B. 97.

4. Cash Compensation Programs

Cash compensation programs take a variety of forms ranging from discretionary cash bonuses to bonuses tied to profitability or other objective performance standards.

Cash compensation to an employee (including payments under an SAR) generally is taxable as ordinary income to the employee in the year of receipt.[14] The employer is entitled to a corresponding deduction, usually in the year of payment.[15]

A cash compensation program that approximates some elements of stock ownership is a stock appreciation right ("**SAR**"), also known as "phantom stock" or a "performance share." An SAR is an unsecured obligation of the employer to pay an employee additional cash compensation equal to any increase in the value of a designated number of shares of employer stock from the date of grant to a later measurement date. SARs that pay off when an employee exercise an option are sometimes used to provide cash to pay the exercise price.[16] Employers might find SARs useful when an increased number of shareholders or outstanding shares is not desired, but the employer wants the employee to participate in the appreciation of the employer's stock. True SARs are rarely used for closely-held businesses because the value of the stock cannot be readily measured.

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[14] Constructive receipt principles and new Section 409A apply under certain circumstances to require taxation before the year of actual payment.

[15] An employer using the accrual method of accounting for tax purposes may accrue the deduction in the year prior to payment if (a) the payment is made within two and one-half months after the employer's year-end, (b) by year-end the obligation to pay the compensation is fixed *and* the amount of payment is determinable, and (c) the employee does not own (applying ownership attribution rules), in the case of an employer that is a C corporation, more than 50% in value of the employer's stock or, in the case of an employer that is an S corporation, any employer stock.

[16] In this strategy, the employer is betting that in the year the SAR pays off the employer will be sufficiently profitable to use the deduction resulting from the payment to the employee.

5. **Deferred Compensation Arrangements and New Section 409A**

In 2004 new federal tax rules were enacted for plans and agreements that pay compensation more than 2½ months after the end of the year in which in which the services were rendered.[17] The payment can be treated for tax purposes as received before it is actually paid and penalty taxes can apply if the plan or agreement does not comply with these rules. *Many pre-2005 arrangements must be amended in 2005 to comply with these rules, or face very bad tax consequences.*

Analysis

Closely-Held Company, Not an IPO Candidate. The holding period requirements make the ISO virtually useless when the employer's stock is not publicly traded and it is not going to go public. In a closely-held company, the employee will rarely exercise the option except at termination of employment (in which case the employer generally will buy the shares back) or the sale of the company (in which case the buyer will buy the shares or the company will liquidate). In either case there is rarely an opportunity to hold the shares for a year after exercise.[18]

In a profitable closely-held company, tax consequences similar to an ISO can be achieved if the employer pays the employee an cash bonus to cover the employee's tax cost of acquiring the shares. This works well for a stock bonus or a bargain sale of stock, but does not work well for a stock option (because the employer might not have sufficient profit in the year of exercise to use the deduction generated by the exercise and the cash bonus). For a profitable employer, this method "trades" the employer's tax benefit of its deduction for the employee's tax detriment of the additional tax on the spread. The employee takes a tax basis in

[17] I.R.C. § 409A.

[18] Permitting "cashless exercise" (the use of the spread on some options as cash to pay the exercise price on other options) makes it easier to exercise and satisfy the holding period requirement, but many owners of closely-held businesses are not anxious to make it easier to exercise. Often the grant of an NQSO is sufficient to satisfy the employee who "wants in."

the shares equal their fair market value on the date that the employee receives them (assuming there is no SROF or, if so, a Section 83(b) election is made).

IPO Candidate or Public Company. For an employee of an IPO candidate or a publicly-traded company, the holding period requirement is more manageable because the employee can obtain a margin loan or sell shares to raise the exercise price ... and to pay the AMT on exercise of the ISO.

ISOs are an especially attractive form of deferred compensation because the employee does not recognize gain until the ultimate disposition of the stock, and gain on disposition is taxed at preferential long-term capital gain rates -- a maximum rate of 20% (compared to maximum ordinary federal income tax rates of 38.6%). Although the employer is denied a deduction, this detriment often is outweighed by the tax benefits to the employee. But the benefit of the employer's deduction with respect to a NQSO or cash compensation is almost meaningless if the employer has no profit or substantial NOL carryforwards, or the employee has a much higher tax rate than the employer.

The tax deferral value of an ISO to the employee will depend on how long the employee holds the ISO stock after the ISO holding period[19] expires.

Other factors might reduce the deferral value of an ISO. For example, the deferral value is diminished if the employee "hits a home run" and is therefor subject to the alternative minimum tax in the year the ISO is exercised (because the deferred income at exercise of the ISO is an AMT adjustment).

A present value analysis of these factors is necessary to determine the net relative value of an ISO to the employee compared to a NQSO or cash compensation. The net value to the employee and the employee's expectations must be weighed against the value of a deduction to the employer in determining whether NQSOs or cash compensation programs should be used instead of ISOs. *If the employer's tax bracket equals or exceeds the employee's tax bracket, the value of the employer's deduction resulting from exercise of an NQSO or payment of cash*

[19] To satisfy the ISO holding periods, the shares must be held for two years after the date of grant and one year after exercise.

compensation will always be greater than the value of the limited tax deferral to the employee resulting from ISO stock.

The following factors might also induce employers to issue ISOs (and to lose their deduction):

(a)If a deduction to the employer will save little, if any, taxes (because the employer has low taxable income taxed at low rates, or no taxable income because of current operating losses or net operating loss carryovers; read "dot.com"), the NQSO provides little or no benefit to the employer, while the employee can still benefit from the ISO. If and when the employer's tax situation changes, the employer can consider issuing NQSOs on a prospective basis.

(b) Non-tax considerations (for example, the employees' expectations, if any, of receiving ISOs rather than NQSOs) might minimize or eliminate the benefit to the employer of issuing NQSOs.

To preserve flexibility, the employer might consider adopting a "**dual**" stock option plan that permits granting either ISOs or NQSOs. This might be important if in the future it will be difficult or expensive to obtain shareholder approval for a new plan.

Compensation consultants can provide substantial value when an employer is considering a deferred compensation plan, including a stock-based plan. The

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consultant can obtain frank input from employees and can tell the employer what similar employers are doing for their employees.

We have a wealth of experience in designing, drafting and reviewing incentive compensation arrangements and are familiar with the tax and corporate law issues involved. We would be pleased to discuss these matters with you.

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