

Taxation of stock options and restricted stock: Basics and beyond

The compensation mantra for many companies today is “pay for performance.” As a result, companies often focus on equity-based compensation in order to align the interests of executives with those of the company’s shareholders. The most popular forms of equity-based compensation are stock options and restricted stock. It is not uncommon for these vehicles to compose a substantial portion of an executive’s net worth.

Accordingly, it is important that executives fully understand the income tax treatment of options and restricted stock in order to maximize the after-tax value. This article presents the basic tax rules that apply to stock options and restricted stock, but also goes beyond the basics to discuss several more complex issues and planning considerations. Throughout the article, we will refer to “Jane,” an executive of a hypothetical company called “Public Company,” in order to illustrate the various tax rules. We begin with a discussion of Jane’s incentive stock options.

Incentive stock options

Assume that Jane holds 1,000 incentive stock options (ISOs). If Jane is like most executives, she is very pleased to hold ISOs due to their very favorable tax treatment, which include:

- There is no income tax when:
 - Public Company *grants* the ISOs to Jane
 - The ISO vests
 - Jane *exercises* the ISOs
- There is income tax when Jane *sells* the stock

The following example illustrates the tax treatment of ISOs.

Example 1: Jane exercises her 1,000 ISOs. She receives 1,000 shares of Public Company. Jane pays \$10 per share for the stock (i.e., the exercise price is \$10). Three years later, she sells the stock for \$15 per share. As noted above, she pays no tax until she sells the shares. At that time, she has a capital gain of \$5 per share, or \$5,000 in total, calculated as follows:

Sales price per share	\$15
Minus exercise price per share (basis in the shares)	-10
Equals gain per share	\$ 5
Times number of shares sold	x <u>1,000</u>
Equals total gain	\$5,000

The gain is a long-term capital gain because Jane held the stock for more than one year.¹ This very favorable tax treatment — the deferral of income recognition until the stock is ultimately sold — may seem too good to be true. In fact, there are situations in which such favorable tax treatment will not apply to ISOs.

Disqualifying dispositions

Specifically, an ISO loses its favorable tax treatment if there is a so-called “disqualifying disposition.” A disqualifying disposition occurs whenever the stock that was acquired with an ISO is sold within:

- Two years after the ISO is *granted*, or
- One year after the ISO is *exercised*.²

If Jane sells the stock within either of the periods above, she will be required to report income in the year of the disqualifying disposition.³ Further, the income is ordinary income rather than a capital gain. The income amount is equal to the “spread” on the exercise date (i.e., the difference between the fair market value of the stock on the exercise date and the exercise price).⁴ To illustrate this tax treatment, we will return to the prior example with a few changes in the facts.

Example 2: As in Example 1, Jane exercises 1,000 ISOs and receives 1,000 shares of Public Company. The exercise price is \$10 per share. At the time of exercise, the fair market value of the stock is \$12 per share. Only six months later, Jane sells the stock for \$15 per share. Jane has a disqualifying disposition because she sold the stock within one year after the ISO was exercised. As a result, Jane will recognize ordinary income in the year of the disqualifying disposition, calculated as follows:

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

In addition, Jane will report a capital gain upon the sale of the stock.⁵ The gain will be a short-term gain, because

¹ Section 1222(3).

² Section 422(a)(1).

³ Section 421(b); Reg. 1.421-2(b).

⁴ Public Company will obtain an income tax deduction equal to the amount of Jane’s ordinary income. Section 83(h); Reg. 1.83-6(a).

⁵ Public Company will not obtain any deduction related to Jane’s capital gain.

she has held the stock for less than one year. The amount of her capital gain is calculated as follows:

Sales price per share		\$15
Minus Jane's basis in the stock:		
Exercise price per share	\$10	
Ordinary income per share, recognized as a result of the disqualifying disposition	+ <u>2</u>	
Total basis in the stock per share		- <u>12</u>
Equals capital gain per share		\$ 3
Times number of shares sold		x <u>1,000</u>
Equals total capital gain (short-term)		\$3,000

In the example above, Public Company's stock continues to increase in value. Of course, this is not always the case. Suppose that shortly after Jane's exercise of the ISOs (when the stock value is \$12 per share), the stock begins to decline in value. When the stock reaches \$11 per share, Jane decides to sell it. Special tax treatment applies when the amount realized upon a disqualifying disposition is less than the stock's value at the exercise date.⁶ Jane will recognize ordinary income as a result of the disqualifying disposition.⁷ The amount is calculated as follows:

Sales price per share		\$11
Minus exercise price per share		- <u>10</u>
Equals ordinary income per share		\$ 1
Times number of shares sold		x <u>1,000</u>
Equals total ordinary income		\$1,000

Jane will not recognize any capital gain or loss, because her entire gain on the stock (i.e., the difference between the sales price and the exercise price) has already been recognized as ordinary income.

Suppose that rather than selling the stock for \$11 per share, Jane continued to hold the stock, and did not sell it until the value declined to \$8 per share. Thus, in contrast to the example immediately above, Jane sells the stock for an amount that is less than the exercise price. In this situation, Jane has a loss of \$2,000, calculated as follows:

Sales price per share		\$ 8
Minus exercise price per share		- <u>10</u>
Equals loss per share		\$ 2
Times number of shares sold		x <u>1,000</u>
Equals total loss		\$2,000

⁶ Section 422(c)(2); Reg. 1.422-1(b)(2)(i); Reg. 1.422-1(b)(3), Example (3)(ii).

⁷ Public Company will obtain a deduction equal to the amount of Jane's ordinary income.

The loss is treated as a capital loss.⁸ Disqualifying dispositions are quite common for ISOs, because many employees sell the shares immediately upon exercise. However, an executive who believes the stock will continue to increase in value is well served to hold onto the stock in order to retain the favorable tax treatment for ISOs that was described earlier.

Alternative minimum tax

It is important that executives are aware of the tax ramifications associated with disqualifying dispositions, including the alternative minimum tax (“AMT”). Exercising an ISO can create income tax liability despite the general rule that the exercise of an ISO is not a taxable event. This is the case because the spread upon exercise is a preference item for AMT purposes.⁹ To illustrate this concept, we return to the earlier examples.

Example 3: Jane exercises 1,000 ISOs at an exercise price of \$10 per share. At the time of exercise, the fair market value of the stock is \$12 per share. Jane’s AMT preference amount upon the exercise is calculated as follows:

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

Of course, this AMT preference item may or may not affect Jane’s actual income tax liability, depending on her overall tax situation.

With proper planning, an executive can minimize the impact of ISO exercises on AMT. It is important that the executive recognize the danger of the AMT. Specifically, if an executive exercises a significant number of ISOs, at a time when the value of the stock has increased dramatically, he or she may have a substantial AMT liability. If the stock later plunges in value – before the executive sells the stock – the executive will have incurred a large tax liability on phantom (i.e., unrealized) gains. There are several strategies to minimize the AMT that an executive may consider, including those strategies which appear in Exhibit 1.

⁸ Reg. 1.422-1(b)(3), Example (3)(iv). Note that Public Company would not obtain any deduction in this scenario.

⁹ Section 56(b)(3).

Exhibit 1

Strategies to minimize the AMT liability associated with ISO exercises

- 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 AMT to be equal amounts.
 - Do not exercise ISOs in excess of this amount, so that there is no AMT.
- Plan ahead.
 - Estimate how many ISOs can be exercised in each future year without triggering AMT.
 - Update the plan each year in the future to reflect changes in the stock value and other circumstances.
- Exercise ISOs as early in the year as possible, and then monitor the stock price throughout the year.
 - If the stock price decreases during the year, and the executive feels the decline may continue, then sell the shares. This results in a disqualifying disposition, but eliminates the AMT preference item. Thus, this technique avoids the payment of AMT on phantom income.
 - If the stock price increases, and the executive feels the stock will continue to increase in value, then consider holding the shares. In this situation, the executive may not be concerned about paying AMT on phantom income, because the increasing value of the stock indicates that the income will eventually be realized when the stock is sold.

ISO limitations and requirements

Executives may wonder why their employers do not issue more ISOs, given the very favorable tax treatment. The reasons that employers may limit the issuance of ISOs include the following:

- The employer receives no income tax deduction for ISOs unless there is a disqualifying disposition.¹⁰
- The employer has the additional administrative burden of tracking disqualifying dispositions and post-exercise tax reporting.
- There is a limit on the number of ISOs that an employer can issue to an employee: \$100,000 per employee on the value of stock for which ISOs can first be exercised each year (i.e., an annual limit). For purpose of this rule, the stock value is measured at the date the options are granted.¹¹

¹⁰ If there is a disqualifying disposition, then the employer will receive a tax deduction equal to the amount of ordinary income recognized by the executive

¹¹ Section 422(d). An employer can adhere to the rule through the vesting schedule that applies to the ISOs. For example, suppose Public Company grants 20,000 ISOs to Jane when the fair market value of the stock is \$10 per share. The total stock value is \$200,000 (20,000 ISOs times \$10). Therefore, no more than 50% of the ISOs may become exercisable in any given year, in order to adhere to the \$100,000 limit.

There are several requirements for an option to be considered an ISO, including the following:

- The exercise price cannot be less than the fair market value of the stock at the time the option is granted¹²
- An ISO can only be granted to an employee, and to retain ISO status, the option must be exercised within three months following termination of employment.¹³
- The option term (i.e., the period during which the option may be exercised) cannot exceed 10 years from the date the option is granted.¹⁴
- The option is exercisable only by the executive, and cannot be transferred to anyone else except upon the executive's death.¹⁵
- At the time the option is granted, the executive cannot own stock possessing more than 10% of the total combined voting power of all classes of stock of the employer or of its parent or subsidiary corporation.¹⁶

This rule does not apply if certain conditions are met, as follows:

- The option's exercise price is at least 110% of the fair market value of the stock on the grant date.
- The option term does not exceed five years from the date the option is granted.¹⁷
- The option plan must be approved by the employer's stockholders within 12 months before or after the date the plan is adopted.¹⁸

Nonqualified stock options

In addition to her 1,000 ISOs, Jane holds 10,000 nonqualified stock options from Public Company. If an option does not meet the requirements for ISO status, then it is a nonqualified option.¹⁹ The tax treatment for nonqualified options is somewhat simpler but less favorable to the executive than ISOs. This treatment is summarized as follows:

- Like ISOs, there is no income recognition upon *grant* or *vesting*.²⁰
- Unlike ISOs, there is income recognition upon *exercise*.²¹

The income that is recognized upon exercise is treated as ordinary income. When the stock is sold later, the individual has a capital gain or loss. The income recognition for nonqualified options is illustrated by the following example.

¹² Section 422(b)(4).

¹³ Reg. 1.421-(h)

¹⁴ Section 422(b)(3).

¹⁵ Section 422(b)(5).

¹⁶ Section 422(b)(6).

¹⁷ Section 422(c)(5).

¹⁸ Section 422(b)(1).

¹⁹ Even when an option does qualify as an ISO, the employer can treat it as a nonqualified option by explicitly stating that it is a nonqualified option. Section 422(b).

²⁰ This assumes the nonqualified option does not have a "readily ascertainable fair market value" on the grant date. An option has a readily ascertainable fair market value if the option (not the stock) is actively traded on an established market. Also, an option that is not actively traded on an established market has a readily ascertainable fair market value if certain conditions are met, two of which are that, on the grant date, the option must be transferrable and immediately exercisable. If the nonqualified option has a readily ascertainable fair market value on the grant date, the option holder recognizes compensation income on the grant date, instead of the exercise date, equal to the value of the nonqualified option

²¹ Reg. 1.83-7(a). This assumes the stock received upon exercise of the nonqualified option is substantially vested within the meaning of Section 83.

Example 4: Jane exercises her 10,000 nonqualified options. The exercise price is \$10 per share, and the stock value on the exercise date is \$15 per share. Jane sells the stock in Year 10 for \$50 per share. Jane recognizes \$50,000 of ordinary income in Year 1 when she exercises the options. The income amount is calculated as follows:

Stock value per share on exercise date		\$15
Minus exercise price per share		<u>-10</u>
Equals ordinary income per share		\$ 5
Times number of options exercised		x <u>10,000</u>
Equals ordinary income		\$50,000 ²²

When Jane sells the stock in Year 10, she will have a capital gain, calculated as follows:

Sales price per share		\$50
Minus Jane’s basis in the stock:		
Exercise price per share	\$10	
Ordinary income per share previously recognized	<u>+ 5</u>	
Total basis in the stock per share		<u>- 15</u>
Equals capital gain per share		\$35
Times number of shares sold		x <u>10,000</u>
Equals total capital gain		\$350,000

The capital gain is a long-term capital gain because Jane held the stock for more than one year.

Employer loan to fund stock option exercise

An employer sometimes extends a loan to an executive so that the executive has the cash to pay the exercise price of stock options. The loan does not change the tax treatment of the options that has been discussed above, unless the loan has certain characteristics. To illustrate, suppose Public Company gives Jane a loan to fund the exercise of her nonqualified options. Suppose further that the stock serves as security for the loan, and Jane is not personally liable to repay the loan. In this situation, Jane’s exercise of the options is ignored for tax purposes.²³ This is the case because Jane has not taken on any personal risk that the value of the stock will decline. Therefore, there has been no transfer of stock for tax purposes. Jane should not report income upon the exercise. Jane will not report income until the loan no longer exists. It should be noted that if the loan is from a third party rather than from the employer, then the usual taxation rules apply.²⁴ In other words, the special rules described in this paragraph apply only when the loan is from the employer.

²² When Jane recognizes the income, Public Company will obtain a tax deduction equal to Jane’s income (i.e., \$50,000).

²³ Reg. 1.83-3(a)(2); Reg. 1.83-3(a)(7), Example (2).

²⁴ Palahnuk v. U.S., 97 AFTR 2d 2006-1433.

Restricted stock

In addition to her ISOs and nonqualified stock options, Jane holds 5,000 shares of restricted stock issued by Public Company. The term “restricted stock” means that the shares have actually been transferred to Jane, but must be returned to Public Company if she does not continue to work there for a specified amount of time (e.g., five years). This condition on keeping the stock is referred to as a “substantial risk of forfeiture,” or more simply as “vesting.”

There is no income reported for restricted stock until the year in which the stock vests.²⁵ At that time, ordinary income is recognized, and the amount is calculated as follows:

- Fair market value of the stock on the vesting date
- Minus the amount the individual was required to pay for the stock (if any) equals ordinary income²⁶

Later, when the executive sells the stock, a capital gain is recognized. The income recognition for restricted stock is illustrated by the following example:

Example 5: Jane’s 5,000 shares of restricted stock all vest in Year 5. On the vesting date, the fair market value is \$30 per share. Jane sells the stock in Year 8, when the fair market value is \$40 per share. Jane will report \$150,000 of ordinary income when she vests in Year 5, calculated as follows:

Fair market value per share at vesting date	\$30
Times number of shares	x <u>5,000</u>
Equals total ordinary income	\$150,000

When Jane sells the stock in Year 8, she will report a capital gain of \$50,000, calculated as follows:

Sales price per share	\$40
Minus ordinary income per share previously recognized (i.e., Jane’s basis in the stock)	- <u>30</u>
Equals capital gain per share	\$10
Times number of shares sold	x <u>5,000</u>
Equals total capital gain	\$50,000

The capital gain holding period begins on the date the stock vests.²⁷ The gain is a long-term capital gain, because Jane held the stock for more than one year after the vesting date.

Section 83(b) election

If Jane so chooses, she can report income in the year the stock is transferred to her, prior to vesting. This is known as a “Section 83(b) election.” When a Section 83(b) election is made, the amount of income that is recognized is based on the stock’s fair market value on the grant (i.e., transfer) date. Later, when the stock is sold, there is a

²⁵ Section 83(a).

²⁶ Public Company will obtain a tax deduction equal to Jane’s ordinary income amount.

²⁷ Reg. 1.83-4(a).

capital gain. For purposes of determining whether the gain is a short-term or long-term gain, the holding period begins on the date the stock is transferred, rather than the vesting date.²⁸

The income recognition when a Section 83(b) election is made is illustrated by the following example.

Example 6: Assume the same facts as in Example 5 above. In addition, assume that the fair market value of the stock on the day in Year 1 that it was granted to Jane was \$10 per share. Jane makes a Section 83(b) election to recognize income upon the grant of the restricted stock in Year 1.²⁹ As a result, Jane will report \$50,000 of ordinary income in Year 1, calculated as follows:

Fair market value per share at grant date	\$10
Times number of shares	x <u>5,000</u>
Equals total ordinary income	\$50,000

When Jane vests in the stock in Year 5, there is no income recognition because Jane chose to have income recognized in Year 1.

When Jane sells the stock in Year 8, she will report a capital gain of \$150,000, calculated as follows:

Sales price per share	\$40
Minus ordinary income per share previously recognized (i.e., Jane’s basis in the stock)	- <u>10</u>
Equals capital gain per share	\$30
Times number of shares sold	x <u>5,000</u>
Equals total capital gain	\$150,000

The gain is a long-term capital gain because Jane held the stock for more than one year from the grant date.

The table below summarizes Jane’s income recognition both with and without a section 83(b) election.

	No Section 83(b) election	With a Section 83(b) election
Ordinary income	\$150,000	\$ 50,000
Capital gain	50,000	150,000
Total	\$200,000	\$200,000

Under both scenarios, the total income recognized by Jane is \$200,000. However, the two scenarios vary significantly in the composition of the income. When Jane makes a Section 83(b) election, a large portion of the

²⁸ Reg. 1.83-4(a).

²⁹ Public Company will obtain a deduction in Year 1 equal to the amount of Jane’s ordinary income

appreciation in the stock's value is taxed at the more favorable capital gains rate. In contrast, when Jane does not make a Section 83(b) election, most of the gain is taxed at ordinary income tax rates.

While a Section 83(b) election may result in the optimal tax treatment, the decision to make the election should not be taken lightly. In the example above, Jane reports \$50,000 of ordinary income in Year 1, even though the stock does not vest until Year 5. Suppose Jane leaves Public Company in Year 3; as a result, she does not vest in the stock. Unfortunately, the law does not permit Jane to recover the income taxes she paid in Year 1. She has reported \$50,000 of income that she never actually received. This is the risk associated with a Section 83(b) election.

Restricted stock plans are sometimes designed so that the executive is required to pay some amount for the stock. When an executive makes a Section 83(b) election and later forfeits the stock, a capital loss is recognized equal to the amount paid for the stock.³⁰ For example, if Public Company had required Jane to pay \$1 per share for the stock in Year 1, or a total of \$5,000, she would report a capital loss of \$5,000 on her income tax return for Year 3 when she forfeited the stock.

The example above highlights the considerable risk associated with a Section 83(b) election. However, when the stock has little value on the grant date, then the income reported as a result of the election is some relatively small amount, resulting in little to no risk in making the election.

Given the risk associated with a section 83(b) election, a common question is whether the election can ever be revoked. An election cannot be revoked without IRS approval.³¹ If the executive seeks the revocation within the first 30 days after the stock is granted, the IRS will approve the revocation.³² After that, the IRS will approve a revocation only when the executive made the election under a "mistake of fact." A mistake of fact is "an unconscious ignorance of a fact that is material to the transaction."³³ The failure of the executive to understand the substantial risk of forfeiture associated with the restricted stock is not a mistake of fact. In addition, the failure of the executive to understand the tax consequences of making the Section 83(b) election is not a mistake of fact.³⁴ A mistake as to the value of the stock is also not considered a mistake of fact.³⁵

Even when there has been a mistake of fact, the IRS will not approve a revocation unless the request is made within 60 days of the date on which the mistake of fact first became known to the executive.³⁶

Executive considering whether to make a Section 83(b) election should take into account the various advantages and disadvantages of the election. The major advantages and disadvantages are summarized in Exhibit 2.

³⁰ Reg. 1.83-2(a).

³¹ Section 83(b)(2).

³² Rev. Proc. 2006-31, 2006-27 IRB 13.

³³ *Id.*

³⁴ *Id.*

³⁵ Reg. 1.83-2(f).

³⁶ *Id.*

Exhibit 2 Section 83(b) elections: major advantages and disadvantages	
Advantages	Disadvantages
<ul style="list-style-type: none"> • Capital gain holding period begins at grant date rather than at vesting date • If the stock value increases, more of the appreciation is treated as capital gain 	<ul style="list-style-type: none"> • Accelerates the payment of taxes (an issue if the stock has high value on transfer date) • If the stock value decreases between the grant date and vesting date, the election results in a larger amount of ordinary income than would have been the case without the election • If the stock is forfeited, there is no loss deduction (except for the amount, if any, paid by the executive for the stock)

Certain procedures must be followed in order to have a valid Section 83(b) election.³⁷ These procedures include the following:

- The election must be made within 30 days of the stock transfer.³⁸
- The election must be sent to the IRS.³⁹
- A copy of the election must be given to the employer.⁴⁰

Dividends on restricted stock

Sometimes an employer pays dividends on restricted stock. When this occurs, the tax treatment of the dividend depends on whether a Section 83(b) election has been made. If no Section 83(b) election has been made, then the dividend is treated by the individual as compensation income (i.e., ordinary income).⁴¹ On the other hand, dividends on restricted stock for which a Section 83(b) election has been made are treated as dividend income rather than compensation.⁴²

Substantial risk of forfeiture

As discussed above, the value of restricted stock is included in the executive's income when it is no longer subject to a substantial risk of forfeiture. Thus, it is important to determine when a substantial risk of forfeiture lapses so that income is reported at the proper time.

³⁷ Section 83(b)(2).

³⁸ Reg. 1.83-2(b).

³⁹ Reg. 1.83-2(c).

⁴⁰ Reg. 1.83-2(d).

⁴¹ Reg. 1.83-1(f), Example (1).

⁴² Rev. Rul. 83-22, 1983-1 CB 17; Rev. Proc. 83-38, 1983-1 CB 773.

The term “substantial risk of forfeiture” means the “future performance of substantial services.”⁴³ In addition, a substantial risk of forfeiture exists when vesting is contingent upon the “occurrence of a condition related to the purpose of the transfer.”⁴⁴ For example, vesting that is based on an increase in the employer’s earnings constitutes a substantial risk of forfeiture. The determination of whether a risk of forfeiture is substantial is based on all surrounding facts and circumstances. One common question relates to how long the vesting period must be in order for the risk of forfeiture to be substantial. There is no clear answer to this. However, the regulations include an example in which two years is treated as a substantial risk of forfeiture.⁴⁵

Special care must be taken in determining whether there is a substantial risk of forfeiture on the part of an executive who owns a significant amount of the total combined voting power or value of all classes of stock of the employer. The regulations provide general guidelines for this situation, followed by two examples. The guidelines focus on the executive’s relationship with, and degree of control over, the other shareholders. In the first example, the executive owns 20% of the employer’s stock, with the remaining 80% owned by unrelated individuals. In this example, the regulations state that there is a substantial risk of forfeiture. In the second example, the executive holds 4% of the voting power of all of the employer’s stock, with the remaining stock held “diversely” by the public. In this example, the regulations state that there is not a substantial risk of forfeiture.⁴⁶

Even though a substantial risk of forfeiture exists, the value of the stock must be included in the executive’s income if the stock is transferable to another party, and that party is not subject to the substantial risk of forfeiture.⁴⁷ It seems unlikely that an employer would allow this type of transfer.

There is a special rule related to Section 16(b) of the Securities Exchange Act of 1934, which addresses the sale of stock at a profit within six months after the purchase of the stock. During this restriction period, the stock is treated as both subject to a substantial risk of forfeiture, and not transferable. Thus, there is no taxable event until the Section 16(b) restriction period ends.⁴⁸ Any other restrictions that apply under various securities laws are not accorded this same treatment; thus, stock that is otherwise vested is subject to tax, despite these restrictions.⁴⁹

Restricted stock units

It is important for executives to understand the differences between restricted stock and restricted stock units (“RSUs”). In the examples above, Jane received restricted stock in Year 1 that vested in Year 5. The stock was actually transferred to Jane in Year 1, subject to the restriction that she remain with Public Company through Year 5 in order to vest in the stock. If Public Company had instead chosen to use RSUs, there would have been no actual transfer of stock to Jane in Year 1. Instead, Public Company would have simply made a commitment in Year 1 that it would transfer the stock to Jane in Year 5, as long as she was still employed in Year 5. From a tax perspective, a key distinction between restricted stock and RSUs is that a Section 83(b) election is not permitted in connection with RSUs, because there is no transfer of stock prior to vesting. In the case of RSUs, the value of the stock is

⁴³ Section 83(c)(1).

⁴⁴ Reg. 1.83-3(c)(1).

⁴⁵ Reg. 1.83-3(c)(4), Example (1).

⁴⁶ Reg. 1.83-3(c)(3).

⁴⁷ Section 83(c)(2).

⁴⁸ Section 83(c)(3).

⁴⁹ Rev. Rul. 2005-28, 2005-19 IRB 997

included in income on the date the stock is transferred to settle the RSU, which may be after the vesting date. The income amount is the fair market value of the stock on the date the stock is transferred.

Income tax withholding and employment taxes obligations

For purposes of cash flow planning, it is important to understand the income tax withholding and employment tax obligations that apply to stock options and restricted stock. With respect to ISOs, there is no federal income tax withholding requirement, even when the executive has a disqualifying disposition.⁵⁰ Similarly, no Federal Insurance Contributions Act (FICA), which includes Medicare and social security taxes) taxes or Federal Unemployment Tax Act (FUTA) taxes apply to ISOs.⁵¹

With respect to both nonqualified stock options and restricted stock, income tax withholding is required, as well as the payment of FICA and FUTA taxes. These obligations occur at the same time the executive recognizes income. Thus, for nonqualified stock options, these obligations arise on the exercise date. For restricted stock, the obligations arise when the stock becomes vested. However, if a Section 83(b) election is made, then the obligations arise when the election is made, rather than on the vesting date. The total FICA tax rate is 7.65%, payable by both the employer and the executive (i.e., a combined tax rate of 15.3%).⁵² Of this amount, 6.2% is paid on a limited amount of inflation-adjusted income (\$160,200 in 2023), and many executives will reach this limit without regard to any income attributable to nonqualified stock options or restricted stock. The remaining 1.45% is applied to total income with no limitation, and can be a significant amount with respect to nonqualified options and restricted stock. In addition to normal FICA taxes, the employer is required to withhold from the employee's wage an additional 0.9% Medicare tax on an employee's wages in excess of \$200,000. The employer's FICA tax obligation is not increased by this additional 0.9% Medicare tax. Thus, the fact that these taxes are not paid on ISOs presents a distinct advantage of ISOs versus nonqualified options and restricted stock.

The FUTA tax rate is generally only 6%, and is payable on a limited amount of income (\$7,000).⁵³ Thus, FUTA taxes will rarely have any impact on executives with respect to their equity-based compensation.

Next steps

The rules regarding the taxation of stock options and restricted stock are complex. The treatment of disqualifying dispositions and the impact of ISOs on the alternative minimum tax are especially complex. The tax treatment for nonqualified stock options is more straightforward, but there is significant complexity with respect to restricted stock, especially with the decisions of whether to make a Section 83(b) election. It is important for executives to understand these tax rules in order to maximize the after-tax value of equity-based compensation.

⁵⁰ Section 421(b).

⁵¹ Section 3121(a)(22); section 3306(b)(19).

⁵² Section 3101.

⁵³ Sections 3301 and 3302.

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