An Overview of Stock Compensation & Restricted Stock

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Disclaimer

Agenda

- Incentive Stock Options
  - Tax implications at grant date and vesting date
  - Disqualifying Dispositions
  - AMT Impact
  - Other planning considerations
- Nonqualified Stock Options
  - Tax implications at grant date and vesting date
  - Cash flow planning and other considerations
- Restricted Stock
  - Tax implications at transfer date and vesting date
  - 83(b) Elections
- Other Considerations & Planning

Incentive Stock Options

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Meet John

- John is an executive at a large private company
- John is 57 years old and plans on retiring in the next 5-7 years
- John owns a substantial amount of the company's stock which makes up around 75% of his overall net worth
- In addition, John's compensation includes the following:
  - Incentive stock options
  - Nonqualified stock options
  - Restricted stock

Incentive Stock Options (ISOs)

- John owns 10,000 incentive stock options
- 7,500 of these are vested and 2,500 are not vested
- "Vested" – Options can be exercised once they are vested
  - The "company stock plan" agreement will specify the vesting arrangements
  - Typically options vest over a multi-year period (i.e. 25% each year over the next four years)
  - If terminated, the executive may lose all vested and non-vested options
  - In some cases there is a grace period to allow the employee to exercise vested options

Why is John so happy to have ISOs?

- **ISOs have favorable tax treatment**

- **No income is recognized at the grant date**
  - The grant date is the date John was given the ISOs
  - At the grant date, typically none of the options are vested
  - In this case John was granted 10,000 ISOs on 1/1/2017 of which 2,500 vest each year

- **No income is recognized at the exercise date**
  - When the options vest, if John chooses to exercise the ISOs, there is no income recognized at this time.

John will pay tax when he sells the shares

- Suppose John exercises 1,000 shares at the exercise price of $10
- Four years later, John sells the stock for $15 per share
- In the year of sale, John will recognize a long-term capital gain of $5,000:

Sales Price per share	$15
Less: exercise price	- $10
Gain per share	= $5
Times number of shares	* 1,000
Equals total capital gain	**$5,000**

What if John sells the stock for a loss?

- Suppose John exercises 1,000 shares at the exercise price of $10
- Four years later, John sells the stock for $7 per share
- In the year of sale, John will recognize a long-term capital loss of $3,000:

Sales Price per share	$ 7
Less: exercise price	- $10
Loss per share	=($3)
Times number of shares	* 1,000
Equals total capital loss	**($3,000)**

Be aware of disqualifying dispositions!

- **Disqualifying disposition IF ISO shares are sold within:**
  - 2 years after the ISO was granted
  - 1 year after the ISO is exercised

- **Disqualifying dispositions cause ISOs to lose their favorable tax treatment:**
  - John would be required to report income in the year the disqualifying disposition occurs
  - Income equals the "spread amount" at exercise

Tax Implications of Disqualifying Disposition

- Suppose John exercises 1,000 shares at the exercise price of $10 (at the time of exercise, FMV was $13 per share)
- Immediately upon exercising, John sells the stock for $15 per share
- John will recognize ordinary income of $3,000:

Stock value at exercise date	$13
Less: exercise price	- $10
Equals spread (ordinary income)	=$3
Times number of shares	* 1,000
Total ordinary income	**$3,000**

In addition, John will have a capital gain

- Same facts: John exercises 1,000 shares at the exercise price of $10 (at the time of exercise, FMV was $13 per share)
- Immediately upon exercising, John sells the stock for $15 per share
- John gets basis for the ordinary income that was recognized
- John will recognize a short-term capital gain of $2,000:

Sales price	$15
Minus John's basis in the stock	- $13 ($10 exercise + $3 income)
Equals capital gain	=$2
Times number of shares	* 1,000
Total capital gain (short-term)	**$2,000**

Disqualifying Disposition when Stock Value Declines

- Suppose John exercises 1,000 shares at the exercise price of $10 (at the time of exercise, FMV was $13 per share)
- Six months after exercising, John sells the stock for $12 per share
- John will recognize ordinary income of $2,000
- There is no capital gain or loss since the entire difference between the sales price and exercise price has been recognized as ordinary income

Sales price	$12
Less: exercise price	- $10
Equals spread (ordinary income)	=$2
Times number of shares	* 2,000
Total ordinary income	**$2,000**

John follows our recommendations on avoiding disqualifying dispositions

- John is probably wondering why his company doesn't issue more of these
- **Two reasons:**
  1. Companies are limited to granting $100,000 of ISOs which can be exercised per year (based on FMV at grant date)
  2. There is no tax deduction to the company (unless there is a disqualifying disposition)

Later, John exercises ISOs and he's not happy!

- John calls and says he thought there is no income at the grant date or exercise date, why is he owing tax?
- The reason is due to Alternative Minimum Tax (AMT)
- At the exercise date, the spread is treated as a preference item for AMT

Fair market value at exercise	$12
Less: exercise price	- $10
Equals spread	=$2
Times number of shares	* 1,000
Total AMT Preference	**$2,000**

*Depending on the taxpayer's specific tax situation, the AMT preference may not result in additional tax

Now John goes to sell the shares

- **The basis for AMT and regular tax will be different**
- For regular tax, it will be the exercise price
- For AMT purposes, the basis will be the exercise price PLUS the AMT preference from the year of exercise:

Exercise price	$10
Plus AMT preference	+ $2
Equals AMT Basis	=$12
Times number of shares	*1,000
AMT basis in year of sale	**$12,000**
Regular basis in year of sale	**$10,000** ($10 * 1,000 shares)
AMT Preference in year of sale	**($2,000)**

Cash Flow Concerns from Exercising ISOs

- **When John chooses to exercise ISOs, he will need to come up with enough cash for the following:**
  1. The purchase price of the ISOs (i.e. 1,000 shares at $10 exercise price - $10,000)
  2. The taxes associated with the exercise (most likely resulting from the AMT)
- **This presents a couple problems:**
  1. If it is not a publicly traded company, you may not be able to sell any stock to pay for the exercise and taxes.
  2. If the stock is publicly traded and you choose to sell some of the stock, you will likely be triggering a disqualifying disposition.

Potential Cash Flow Solutions

- For public companies, once the executive has ISO shares that have met the holding period requirements, then the executive can sell these shares in order to generate cash
- Some companies allow "cashless exercises" in the form of a tax-free exchange:
  1. This allows an executive to turn in shares that were previously exercised
  2. The exchange shares have the same basis as the shares you turned in (carryover basis)
  3. The added shares have a basis equal to amount of cash you paid (which may be $0 or close to $0)
  4. The rules dictating these tax-free exchanges are fairly complex and not all companies permit these

ISO Reporting

- The AMT preference of ISOs from exercising should be entered on Line 14 of Form 6251 (a positive number)
- The AMT preference from ISOs when sold should be entered on Line 17 (a negative number)

7 Tax refund from Form 1040, line 10 or line 21	7	
8 Investment interest expense (difference between regular tax and AMT)	8	
9 Depletion (difference between regular tax and AMT)	9	
10 Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	10	
11 Alternative tax net operating loss deduction	11	
12 Interest from specified private activity bonds exempt from the regular tax	12	
13 Qualified small business stock (7% of gain excluded under section 1202)	13	
14 Exercise of incentive stock options (excess of AMT income over regular tax income)	14	33,031.
15 Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	15	
16 Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	16	
17 Disposition of property (difference between AMT and regular tax gain or loss)	17	
18 Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	18	
19 Passive activities (difference between AMT and regular tax income or loss)	19	

ISO Reporting - continued

- The exercise of ISOs is required to be reported on Form 3921 (similar to 1099 requirements)
- It will show the exercise price and FMV at the date of exercise.

FORM 3921 • Exercise of an Incentive Stock Option Under Section 422(b)

Account number (see instructions)	(Box 1) Date option granted	(Box 2) Date option exercised	(Box 3) Exercise price per share	(Box 4) Fair market value per share on exercise date	(Box 5) No. of shares transferred	(Box 6) If other than TRANSFEROR, name address, and EIN of corporation whose stock is being transferred
FU-N -0000021	04/25/2007	04/01/2014	$ 50.70	$ 67.45	1972	

Key Requirements for ISOs

- Option term cannot exceed 10 years
- Exercise price cannot be less than fair market value at grant date
- Option is not transferrable (except at death)
- Options cannot be granted to employees that own 10% or more of the combined voting stock of the corporation, parent or subsidiary corporation
  - This rule is waived if the exercise price is at least 110% of the FMV and the option term is limited to 5 years from grant date

Basic ISO Planning to Minimize the AMT

- Limit the number of ISOs that are exercised each year
- Use projections to estimate how many options can be exercised each year without triggering AMT
- Exercise ISOs as early in the year as possible for two reasons:
- If the stock price decreases during the year and the decline may continue, you may want to sell the stock
  - This will trigger a disqualifying disposition, but John avoids paying AMT on phantom gains
- If the stock price continues to increase and is expected to increase in the future, then hold the stock
  - There will be an AMT preference, but those gains will eventually be realized when sold

Didn't Tax Reform Eliminate the AMT?

- Significant increase to AMT exemption and related exemption phase-out
- New limit on SALT deduction and investment management fees which were historically the largest AMT adjustments for most taxpayers
- Opportunity to exercise ISOs tax free?

Nonqualified Stock Options

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Nonqualified Stock Options (NQs)

- Nonqualified stock options are any stock options that are not qualified (i.e. ISOs)
- Tax rules are much simpler
- Similar to ISOs:
  - **No income on the grant date**
- Unlike ISOs:
  - **There is income on the exercise date**

John Exercises Nonqualified Stock Options

- John exercises 1,000 nonqualified stock options
- The exercise price is $10 and the fair market value at the exercise date is $15
- At the exercise date, the spread is treated as ordinary income and is reported on John's W-2 (or 1099)

Fair market value at exercise	$15
Less: exercise price	- $10
Equals spread	=$5
Times number of shares	* 1,000
Total Ordinary Income	**$5,000***

*Subject to Federal, state and local withholding as well as FICA (typically just Medicare, since normally over social security max already)

Cash Needed to Exercise NQs

- At the exercise date, John will need the following cash:
  1. $10,000 to purchase the options ($10 * 1,000 shares)
  2. Withholding taxes on the $5,000 of income (around 50%)

- Employers will typically allow employees to perform "cashless exercises" meaning that the employer will net the shares in order to cover the withholdings and cost of the options

When John Sells the Nonqualified Stock Options

- Two years later, John sells the 1,000 shares previously exercised
- The sales price is $20
- John will recognize a $5,000 capital gain from the sale

Sales price	$20
Less basis:	- $15 ($10 exercise + $5 income per share)
Capital Gain	=$5
Times number of shares	* 1,000
Total Capital Gain (LT)	**$5,000**

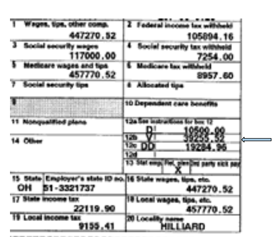
Cash Flow Planning

Here's an example of the payroll tax and withholding implications. In this example, the client would need to pay $131,716 ($118,821 for options and $12,895 to cover the taxes)

W-2 Income:				
# of Shares	Exercise Price	Cost		
2,344	50.70	118,821.18		
-	-	-		
		118,821.18	Basis	
2,344	67.45	158,076.70	FMV	T
		39,255.52	Income on W-2	
Federal (25%)	9,814			
Ohio (3.5%)	1,374			
Hilliard (2%)	785			
Medicare (1.45%)	569			
HI Hosp Ins (.9%)	353			
	12,895	Cash Needed to cover taxes		

W-2 Reporting

The income from nonqualified stock options is reported on a W-2 (or 1099 if for a board member/non-employee). Reported in Box 1 wages with code "V"



Additional Planning Considerations for Nonqualified Stock Options

- As with ISOs, its important to factor into projections to determine how it will affect other items (credits, AMT preferences from ISOs, etc.)
- Typically with nonqualified stock options, it is better to let the investment risks/opportunities drive the decisions since the taxation is the same as regular compensation
- NQs can sometimes be used to generate cash needed to exercise ISOs depending on the specific facts and circumstances

Summary Comparison of ISOs and NQs

	Grant Date	Vesting Date	Exercise Date	Holding Period Requirements
Incentive Stock Options	No income recognized at the grant date	No income recognized at the vesting date	AMT preference recognized equal to spread between FMV and exercise price	1 year from exercise date and 2 years from grant date, otherwise disqualifying disposition occurs
Nonqualified Stock Options	No income recognized at the grant date	No income recognized at the vesting date	Ordinary income recognized equal to spread between FMV and exercise price	None

Restricted Stock

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Restricted Stock Overview

- Restricted stock is not a an option to purchase stock
- Restricted stock is simply defined as stock that is given to an employee with restrictions
- Restricted stock is stock that is actually transferred to the employee, but must be returned to the company if the employee does not continue to work there
  - -This is referred to as "substantial risk of forfeiture" and is the reason the stock is not taxable at the grant date when transferred
- It is typically subject to a vesting schedule (similar to ISOs and NQs)

Restricted Stock Taxation

- **There is <u>no</u> income recognized at the transfer date** (*unless an 83(b) election is made*)
- **There <u>is</u> income recognized at the vesting date** *(unless an 83(b) election has already been made)*

Restricted Stock at Vesting Date

- John has 1,000 restricted stock shares that vested 1/1/2015
- For 2015, John will recognize ordinary income based on the spread (FMV at vesting date less any amount paid for the stock)

Fair market value on 1/1/15	$15
Less amount paid for stock:	- $0
Ordinary Income	=$15
Times number of shares	* 1,000
Total Ordinary Income	**$15,000**

- Typically, companies do not require employees to pay for restricted stock

Later, John Sells the Restricted Stock

- Two years later, John sells the 1,000 restricted stock shares that vested 1/1/2015 for $20 per share
- John will recognize capital gain for the excess of the sales price over the ordinary income previously recognized

Sales Price	$20
Less ordinary income prev. recognized	-$15
Capital gain	= $5
Times number of shares	* 1,000
Total Capital Gain (LT)*	**$5,000**

*Holding period begins on the vesting date

83(b) Election

- An 83(b) election allows John to report the income from restricted stock at the grant date instead of the vesting date
- If an 83(b) election is made, John has income for the FMV of the stock less the amount he is required to pay:

Fair Market Value at grant date	$10
Less amount required to pay	-$0
Ordinary Income	=$10
Times number of shares	* 1,000
Total Ordinary Income	**$10,000**

- By making an 83(b) election, John's ordinary income is based on the FMV at the grant date ($10) instead of the vesting date ($15)
- In addition, the holding period starts on the grant date instead of the vesting date.

Later, John Sells the Restricted Stock

- Two years later, John sells the 1,000 restricted stock shares that he made the 83(b) election for $20 per share
- John will recognize capital gain for the excess of the sales price over the ordinary income previously recognized

Sales Price	$20
Less ordinary income prev. recognized	-$10
Capital gain	=$10
Times number of shares	* 1,000
Total Capital Gain (LT)*	**$10,000**

*Holding period began on the grant date

Comparison of the Income Recognized

- Under both methods, the total income is $20,000
- However, John's overall tax liability will be lower by making an 83(b) election due to the character of the income

	83(b) Election Not Made	83(b) Election Made
Ordinary Income	$15,000	$10,000
Capital Gain	$5,000	$10,000
Total Income	**$20,000**	**$20,000**

Important Factors to Consider Re: 83(b) Elections

- If John makes an 83(b) election, but leaves prior to the stock vesting, there is no recovery of the income taxes were paid
- John can claim a capital loss for any amount that was required to be paid for the stock (i.e. if John paid $1 per share for the 1,000 shares, he could deduct $1,000 as a capital loss)
- If the stock declines in value, John may have paid tax on "phantom appreciation"
- Although there are these risks, if the income from making an 83(b) election will be minimal or $0, there is essentially no risk to making the election. This will preserve all future appreciation as capital gain

Important 83(b) Election Mechanics

- Election must be made in writing and sent to the IRS within 30 days of receiving the stock (a copy is given to the employer)
- No longer required to attach the written election to the tax return when filed
- The election is able to be revoked, but only in certain circumstances

Other Restricted Stock Info

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- Dividends received from restricted stock are treated as compensation income unless there has been an 83(b) election made in which then they are treated as dividend income
- Substantial risk of forfeiture is key! Vesting must be contingent on either:
  - The performance of substantial services in the future
  - The occurrence of a condition related to the purpose (i.e. an increase in salary)
- There can be issues with "substantial risk of forfeiture" if the employee controls the company

What about Restricted Stock Units (RSUs)?

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- Restricted stock units are treated the same as restricted stock, except that the stock is not transferred until vesting
- Its simply a promise by the company to transfer the stock later
- Since the stock is not transferred until vesting, you cannot make an 83(b) election for RSUs
- Some companies may prefer RSUs so that they do not have to track whether 83(b) elections have been made for purposes of their deduction

Summary of Payroll Tax Treatment

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Incentive Stock Options	Nonqualified Stock Options	Restricted Stock	Restricted Stock Units
No payroll taxes, even when there is a disqualifying disposition	Payroll taxes due upon exercise	Payroll taxes due upon vesting (or earlier, if 83(b) election is made)	Payroll taxes due when stock is transferred (or at vesting date if stock is transferred after vesting date)

Tax Reform Update - New 83(i) Election for Private Companies

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- A "qualified employee" may elect to defer the income attributable to a stock option or restricted stock received in connection with the performance of services for up to five years if the corporation's stock is an "eligible corporation."
- Instead of including income at exercise of a stock option or at delivery of fully vested stock, the employee will be subject to income tax at the earlier of the following dates:
  - The date the qualified stock is transferrable;
  - Employee becomes an "excluded employee"
  - Stock of the employer becomes publicly traded
  - Five years after the employee's right to the stock is substantially vested
  - The date the employee revokes the election

Who is an "excluded employee"

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- An individual who becomes a 1 percent owner during the taxable year
- A 1 percent owner of the corporation at any time during the 10 preceding calendar years
- The current or former chief executive officer or chief financial officer of the corporation (or an individual acting in either capacity)
- A family member of an individual described above
- One of the four highest-compensated officers of the corporation during the taxable year
- The four highest-compensated officers of the corporation for any of the 10 preceding taxable years.

Other Related Tax Reform Changes

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- The TCJA keeps the current seven tax brackets, but reduces the rates and changes the income thresholds that apply. The new rates are 10%, 12%, 22%, 24%, 32%, 35%, and 37%, with the top bracket starting at $600,000 for joint filers ($500,000 for single filers)
- The flat supplemental rate of federal income tax withholding on stock compensation is based on the seven brackets. For amounts up to $1 million it is linked to the third lowest rate (22%)
- Publicly traded companies will no longer be able to deduct annual performance-based compensation in excess of $1 million for the CEO, CFO, and the top three highest-paid employees.

Questions?

Thank you!