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Stock-Based Compensation: Tax Effects for Corporations and their Employees

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Stock-based compensation can be an effective way to attract and retain employees. This type of compensation is often used when companies are in the startup phase and/or have limited cash flow available to pay salaries or bonuses. Offering an equity interest in the company in exchange for providing services gives employees a stake in the company's success. In addition, compensation in the form of equity can serve as a retention device as employees may lose their equity interest if they don't remain employed with the company for a certain period of time. Stock-based compensation can be granted in several forms: incentive stock options, nonqualified stock options, and restricted stock or restricted stock units. It's important to understand the tax effect these forms of compensation have on both the employer and employee.

Incentive Stock Options (ISO):

If certain qualifications are met, an employer can grant incentive stock options. ISOs are tax beneficial to employees because income is not recognized when the option is granted or exercised. Instead, a capital gain is recognized when the employee sells the stock in a future year, once minimum holding periods are satisfied (see below). Under current tax law, long-term capital gains receive preferential treatment and are taxed at a minimum of 0% and a maximum of 20%*. Gains from the sale of the stock are subject to a 3.8% net investment income tax as well. Compare that to cash compensation, which is taxed in the year it is paid at an individual's ordinary income tax rate (a maximum of 37% under current law). The combined tax deferral and reduced tax rate make ISOs appealing to employees. Since the employee

does not recognize ordinary income, the employer is not allowed a compensation deduction. However, if the employee disposes of the stock within two years of when it was granted or within one year of when it was exercised, there is no preferential tax treatment. This is commonly referred to as a "disqualifying disposition." The employee will pick up ordinary income, reported on IRS Form W-2, on the date of disposition and will be taxed at ordinary income rates. In this case, the employer is allowed a compensation deduction for tax purposes.

Non-Qualified Stock Options (NQSO):

Non-qualified stock options are options that do not fit the statutory definition of an incentive stock option. Unlike ISOs, employees do not receive favorable tax treatment for these types of options. When NQSOs are used as compensation, the employee recognizes ordinary income at either the grant date or the exercise date. Income recognition occurs at the grant date if the fair market value is easily ascertainable, which typically applies to companies whose stock is traded on an established market. If fair market value cannot be determined on the grant date, income is recognized by the employee when the options are exercised.

The amount of income recognized (reported as income on the IRS Form W-2) is the excess (over the price paid) of the fair market value of the option on the day of exercise. The employee's basis in the shares is the amount of income recognized plus the amount paid for the shares. The holding period of the stock begins when the option is exercised; any gain on a sale of the stock in future years is taxed at capital gain and net investment income tax rates. This type of stock compensation allows the employer to take a corporate tax deduction equal to the amount of income recognized by the employee.

Restricted Stock or Restricted Stock Units (RSUs):

Restricted stock and restricted stock units are two other forms of equity compensation. Restricted stock is subject to certain restrictions and vesting dates. Normally, restricted stocks are taxed when the restrictions have lapsed and the employee has full use of the shares (for example, when the employee can sell the shares). On the date of the lapse, the fair market value is reported as ordinary income to the employee. To offset the tax burden, the employee can take advantage of a special tax provision called an 83(b) election. If the election is made, the individual will have taxable income equal to the fair market

value of the stock on the date of grant rather than the vesting date. This election can be tax beneficial to the employee if the fair value of the company is expected to rise and long periods of time exist between the grant and vesting dates. If the employee never receives full use of the shares, taxes paid due to the 83(b) election are not refunded by the IRS.

RSUs are similar to options. RSUs represent an employer's obligation (albeit unsecured) to grant stock to the employee once the restrictions lapse and the units become vested. The fair market value of the stock on the day the restrictions lapse is ordinary income to the employee. An 83(b) election cannot be made because no actual stock is issued at grant. In the case of restricted stock and RSUs, the employer can take a tax deduction equal to the amount of income the employee recognizes for tax purposes.

Please note that the tax rules relating to equity-based compensation are complex. For further insight into how stock-based compensation could benefit your company, consult your tax professional.

*This article is based on enacted tax law on the date published. It does not consider proposed legislation that may impact the above tax rates.

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