How Employee Stock Options Are Taxed

Article Highlights:

- Non-statutory Option
- Wage Income
- Statutory (Incentive) Options
- Capital Gains
- Alternative Minimum Tax

Many companies, as an incentive to employees to help grow the companies' market value, will offer stock options to key employees. The options give the employee the right to buy up to a specified number of shares of the company's stock at a future date at a specific price. Generally, options are not immediately vested and must be held for a period of time before they can be exercised. Then, at some later date, and assuming the stock price has appreciated to a value higher than the option price, the employee can excise the options (buy the shares), paying the lower option price for the stock rather than the current market price. This gives the employee the opportunity to participate in the growth of the company through gains from the sale of the stock without the risk of ownership.

There are two basic types of employee stock options for tax purposes, a non-statutory option and a statutory option (also referred to as the incentive stock option), and their tax treatment is significantly different.

Non-statutory Option – The taxability of a non-statutory option occurs at the time the option is exercised. The gain is considered ordinary income (compensation) and is supposed to be included in the employee's W-2 for the year of exercise. We say "supposed to be" because it is not uncommon to see smaller firms mishandle the reporting.

The employee has the option to sell or hold the stock he or she has just purchased, but regardless of what he or she does with the stock, the gain, which is the difference between the option price and market price of the stock at the time of the exercise, is immediately taxable. Because of the immediate taxation, most employees who have been granted options will, when exercising their options, immediately sell their stock. Under that scenario, the W-2 will reflect the profit and Form 8949 (the tax form used to report sales of stock and other capital assets) may need to be prepared to show the sale, essentially with no gain or loss, so that the gross proceeds of sale reported on the return are matched up with the sale reported to IRS (on Form 1099-B). If there was a sales cost, such as a broker's commission, then the result would be a reportable loss, albeit usually a small amount. Since the difference between the option price and market price is included in wages, it is also subject to payroll taxes (FICA).

If an employee chooses to hold the stock, he or she would have to pay the tax on the difference between the option price and exercise price, plus the FICA tax, from other funds. If the stock subsequently declines in value, the employee is still stuck with the gain reported when the option was exercised. Any loss on the subsequent sale of the stock would be limited to the overall capital loss limitation of $3,000 per year.

Statutory (Incentive) Options – What makes the taxation of a statutory option different from a non-statutory option is that no amount of income is included in regular income when the option is exercised. Thus, the employee can continue to hold the stock without any tax liability; and, if he or she holds it long enough, any gain would become a long-term capital gain. To achieve long-term status, the stock must be held for:

- More than 1 year after the stock option was exercised, and
- More than 2 years after the option was granted.

The advantage of long-term capital gains is that they are taxed at lower maximum rates. For example, the capital gains tax rate is 15% for a taxpayer who is in the 25% tax bracket.

There is a dark side to statutory options, however. The difference between the option price and market price, termed the spread, is what is called a preference item for alternative minimum tax (AMT) purposes. If the spread is great enough, that might cause the AMT to kick in for the year of exercise. If a taxpayer is already subject to the AMT, this would add to the tax; and, even if not, it might push him or her into the AMT. The current year AMT will be in addition to any tax when the stock is ultimately sold but will establish a higher tax basis for the AMT should it come into play in the year the stock is eventually sold. Not all AMT scenarios can be addressed in this article in detail, so additional guidance may be appropriate.

If the stock is sold before it achieves the long-term holding period requirements described above, the tax treatment is essentially the same as for a non-statutory option.

If you are planning to exercise stock options and have questions, or wish to do some tax planning to minimize the tax bite, please give this office a call.