Incentive Stock Options

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What is it?

An incentive stock option is a right or option granted by the sponsoring corporation to its employees to purchase shares of the corporation's stock at a certain price for a specified period of time, notwithstanding an increase in the value of the stock after the option is granted. It is sometimes referred to as a qualified or statutory stock option.

Example(s): Assume that as a result of her outstanding sales performance during the year, Marissa was given a bonus: an option to purchase 1,000 shares of stock at $10 per share within the next 10 years. Within 15 months, the value of the stock had risen to $15 per share. If Marissa chose to exercise her option at that point, she would pay only $10,000 for stock that was actually worth $15,000.

How do you exercise an incentive stock option?

Typically, an employee exercises the option by paying cash equal to the exercise price or by tendering shares of employer stock that he or she already owns. With respect to the stock method, the employee can engage in a nontaxable stock-for-stock exchange (under Internal Revenue Code Section 1036). Basis in the shares transferred becomes the basis in an equal number of the new shares.

What are the requirements of Internal Revenue Code Section 422?

Incentive stock options provide favorable tax treatment to the employee, but for an option to be considered an incentive stock option for tax purposes, it must satisfy certain requirements set forth in Internal Revenue Code Section 422. These requirements are as follows:

- The incentive stock option may be granted only to an employee of the issuing corporation (or its parent or subsidiary). Employee status generally must be maintained from the grant of the option until its exercise, although an employee may exercise the option within three months following a termination of employment (within one year if disabled).
- The written stock plan must specify the total number of shares that may be purchased. It must also specify the employees or class of employees who are eligible to receive the stock options. Additionally, the plan must be approved by the corporation’s stockholders within 12 months before or after the plan is adopted by the employer's board of directors.
- The option cannot provide that it will not be treated as an incentive stock option.
- The option must be exercised within 10 years after it is granted.
- The option must be granted within 10 years after the earlier of (1) the date the plan was adopted or (2) the date the plan was approved by the stockholders.
- The incentive stock option (by its terms) can be transferred by the employee only at death (through a will or by the laws of descent and distribution). While the employee is alive, only he or she can exercise the option to purchase stock.
- The option exercise price must not be less than the fair market value (FMV) of the stock on the date of grant.
- If the option is granted to a 10-percent-or-more shareholder, the exercise price must be at least 110 percent of the fair market value (FMV) of the stock (rather than 100 percent). Furthermore, the option may not be exercisable after the expiration of 5 years (rather than 10 years from the date the option is granted).
• The maximum total value of the stock (determined as of the grant date) that is first exercisable during any one calendar year may not exceed $100,000 for any one employee. Thus, for example, an incentive stock option award could permit acquisition of up to $500,000 worth of stock if it provided that the options were exercisable in five installments, each of which becomes exercisable in a different year and does not exceed $100,000.

• If the optionee (employee) sells the stock within two years of the date the option is granted, or within one year of the date the option is exercised, the sale is considered a “disqualifying disposition.” Certain transfers of the stock during this time period may also result in a “disqualifying disposition.” A disqualifying disposition results in the loss of favorable tax treatment. In other words, the employee must meet the holding period requirements. The stock acquired under the option must be held for at least two years from the time it is granted and one year from the time it is exercised.

Tip: It is important to note that an incentive stock option may contain additional terms and conditions that are not inconsistent with Internal Revenue Code Section 422. These terms may be more restrictive. For instance, the option exercise price may increase each year. In addition, an option can expire immediately upon termination of employment, rather than allowing an employee to exercise the option during the three-month period following termination.

When can it be used?

• Corporation needs incentive to retain key employees
• Cash bonuses are not available or appropriate
• Executive (or employee) requires stock ownership as incentive
• Stock has long-term growth potential
• Current owners are willing to dilute their ownership

Note that incentive stock options can only be used by corporations; they are not available to the employees of a partnership or limited liability corporation (LLC).

Strengths

Tax deferral

The optionee (employee) does not recognize income or capital gain until a disposition occurs (generally, that means until the stock is sold). Therefore, taxation is deferred. The amount recognized is the difference between the amount paid for the stock and the sale price.

Favorable capital gain rate

Assuming the holding period requirements are met, taxes are measured (in the year the stock is sold) at capital gain rates, which are usually more favorable than ordinary income rates. If the shares are held for at least two years from the date the option was granted and at least one year from exercise, the tax on sale is payable at a long-term capital gain rate. If the holding period requirements are not met, the gain is taxed as a combination of ordinary income and capital gain.

No withholding obligation on corporation

Assuming the holding period requirements are met, there is no withholding tax obligation on the corporation at the time of exercise of the option (because there is no income tax obligation) nor at the time of disposition of the stock. Therefore, compensating an employee with incentive stock options provides cash flow benefits to the corporation not present in other stock compensation arrangements.
Helps business to attract, motivate, and retain key employees

A principal challenge to employers is to attract, motivate, and retain key employees (and executives in particular). These goals can be promoted by giving employees an equity interest in the business. Incentive stock options accomplish this task.

Avoids cumbersome Employee Retirement Income Security Act (ERISA) requirements

Many employers offer qualified retirement plans to employees; generally, such plans are subject to cumbersome ERISA rules pertaining to funding, vesting, disclosure, and other areas. Nonqualified plans are generally not subject to most of ERISA. By selecting a nonqualified plan such as an incentive stock option, you can sidestep the cumbersome aspects of ERISA.

Therefore, from the employer's standpoint, it is wise to structure stock plans in a way that reserves to the employer the greatest degree of discretion with respect to the selection of participants, the size of awards, and the ability to terminate and reduce plan benefits. For practical purposes, this means that employers often offer incentive stock options only to executives—not to rank-and-file employees.

Avoids IRC Section 409A requirements

IRC Section 409A contains complex rules that govern nonqualified deferred compensation (NQDC) plan deferral elections, distributions, funding, and reporting. If a NQDC plan fails to satisfy Section 409A's requirements participants may be subject to current income tax, as well as an interest charge and 20 percent penalty tax. The IRS has stated that Section 409A does not apply to incentive stock option plans.

Provides incentive for the employee by providing an ownership interest in the business

Executives and other employees are much more likely to put forth their best efforts when they have an ownership interest in the business. If the business is successful, the value of the stock will rise (and so will the employee's investment).

Minimizes the use of corporate funds for payment of compensation

Cash flow is increased because the business does not need to pay out cash to provide employees with deferred compensation.

Tradeoffs

Corporation does not get a tax deduction

The corporation is not entitled to any deduction from gross income with respect to the grant or exercise of the incentive stock option or the disposition by the employee of the stock if the relevant holding periods are met by the optionee. If the optionee makes a disqualifying disposition, however, the corporation is entitled to a deduction for a compensation expense equal to the amount of ordinary income recognized by the optionee.

Corporation has less flexibility, due to Internal Revenue Code Section 422

Code Section 422 is fairly restrictive and cumbersome. A corporation might enjoy greater flexibility by offering a nonqualified stock option, which is not subject to Section 422.

Employee may be subject to alternative minimum tax (AMT)

The employee may be subject to AMT in the year of exercise of the stock option because the exercise gives rise to an adjustment of AMT income. More specifically, the excess of the stock's fair market value at the time of exercise over the option exercise price is a tax preference item that may trigger an AMT obligation.
How to do it

Consult an attorney regarding your state's laws

Federal tax law regarding incentive stock options is uniform. It is possible that state law may differ, however, so it is important to consult an attorney to ensure that you understand your state's approach to incentive stock options as well.

Seek the guidance of an attorney and/or certified public accountant to set up your incentive stock option plan

Your plan must comply with the requirements of Internal Revenue Code Section 422. Therefore, it is essential that you consult an employee benefits/Employee Retirement Income Security Act (ERISA) attorney to set up your plan properly. It may be necessary to consult with a certified public accountant as well.

Tax considerations

Income Tax

To the employee

An employee will not recognize any taxable income on the grant of an incentive stock option. Tax is deferred until there is a disposition of the stock. (Disposition means any sale, exchange, gift, or transfer of legal title.) The price at which the option was exercised becomes the taxpayer's basis in the stock.

The tax treatment on the disposition of the stock depends on whether the stock was sold by the employee within the proper holding period. The holding period is the later of two years from the date of grant or one year from the date of exercise by the employee. A disposition of the stock prior to the expiration of the holding period will cause the recognition of "compensation income," which is ordinary income tax treatment on the difference between the fair market value (FMV) of the stock and the option price on the date of exercise. This compensation income recognized is added to the basis of the stock. Any later increase in the value of the stock from the date of exercise to the date of disposition will be treated as capital gain (short- or long-term).

Example(s): Jack was granted an incentive stock option in Year 1 to acquire 1,000 shares of ABC stock at $10 per share. Six months later, he exercised his option when the FMV of the stock was $15 per share. Eleven months after buying the stock, Jack sold his 1,000 shares at $20 per share. Since he did not hold the stock for the required period of time, he has a disqualifying disposition on the date of the sale.

Example(s): In the year of the sale of his stock (the disqualifying disposition), Jack recognizes compensation income of $5 per share ($15-$10). He then adds the $5 per share income to the basis of his stock to arrive at a new basis of $15 per share. When he sells the stock at $20 per share, he has a short-term capital gain of $5 per share ($20-$15).

If the employee complies with the holding period requirements, by comparison, he or she will enjoy the more favorable long-term capital gain treatment when the stock is sold. To receive this tax treatment, the employee must not dispose of the acquired stock for: at least two years from the date the option was granted; and, at least one year after the employee exercised the option.

Caution: The employee may be subject to alternative minimum tax in the year of exercise of the stock option.

To the employer

The corporation is not entitled to any deduction from gross income with respect to the grant or exercise of the incentive stock option or the disposition by the employee of the stock if the relevant holding periods are met by the employee. If the employee makes a disqualifying disposition, however, the corporation is entitled to a deduction for a compensation expense equal to the amount of ordinary income recognized by the employee.
There is no withholding tax obligation on the corporation at the time of exercise of the option or at the time of disposition of the stock.

**Gift and Estate Tax**

*Gifts of incentive stock options*

A gift entails a transfer of the donor's basis in the stock to the donee. A gift of incentive stock option stock should not be made until the statutory holding period has been met. Otherwise, the donor will recognize compensation income equal to the difference between the FMV of the stock and the option price on the date of exercise. Gifts of incentive stock options may be subject to gift tax.

*Death of the incentive stock option holder*

Incentive stock options are includable in the option holder's gross estate for estate tax purposes. In general, the assets of a decedent are afforded a step-up in basis at death, and this rule applies to incentive stock options. A step-up in basis means that the FMV of the stock on the date of the employee's death becomes the new basis for the stock. The basis of unexercised stock options is stepped-up to FMV at death as well.

**Example(s):** If John had an option to purchase $10,000 shares of stock at $10 per share and the value of the stock had risen to $15 per share at his date of death, John’s executor or administrator would use $15 per share (the FMV at date of death) for the stock basis.

**Caution:** If the estate of a person who died in 2010 elects out of the estate tax, assets transferred at death will not receive a step-up in basis but will receive a carryover or modified carryover basis instead.
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