Taxing stock options and other equity-based pay

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You've just received a promotion and are now eligible for equity-based compensation. Congratulations! In most cases, you stand to gain some extra money. But these perks have tax consequences.

The three most common types of equity-based compensation are stock options, restricted stock and restricted stock units. Each will likely be subject to a vesting schedule, which means you have to remain employed for a certain period of time to get them or, if there is a performance-based vesting requirement, certain performance criteria have to be satisfied to earn them. The universe of performance criteria is broad but can include metrics such as total shareholder return, sales targets or individual performance measures.

"As a result of heightened reporting requirements and increased scrutiny placed on compensation paid to key employees, public companies are becoming especially focused on awarding performance-based awards as opposed to awards that vest simply as a result of the passage of time," says Erin Turley, a partner in the law firm of K&L Gates.

Stock options

With stock options, you are given the opportunity to buy a specified number of shares of stock at a set price. The price at which you can purchase a share is called the exercise price. The exercise price must be the fair market value of the stock on the date the option is granted to you. You make money with a stock option if the price of the stock exceeds the exercise price.

"Stock options are 'appreciation awards,' which means that they are valuable only if the price of the employer's stock increases over the exercise price. Employees who receive stock options are, therefore, incentivized to grow the company to ensure value can be realized with respect to their stock option awards," says Allison Wilkerson, a senior associate at K&L Gates.

What kind of option have you been granted? The most common is a nonqualified stock option, or NSO (also called a nonstatutory stock option). The less common type is the incentive stock option, or ISO (also known as a statutory stock option). The ISO gets you the best deal, but it comes with some strings.

Nonqualified stock options

When you exercise a nonstatutory stock option (i.e., buy the stock), the difference between the fair market value of the shares and the exercise price -- called the spread -- will be included in your wages and subject to federal income tax and employment tax withholding. After exercise, you own the shares. When you sell those shares, any gain you recognize will be capital gain (or loss if you sell them at a loss).

Incentive stock options

You get more bang for your buck with an ISO. When you exercise an ISO, you do not include the spread in your income. To be able to exclude the spread from your income, you must meet certain holding requirements.

The stock acquired by exercising the option must be held until the later of:

- One year following the day the stock was transferred to you on exercise.
- Two years after the date the option was granted to you.

If you meet these requirements, when you sell the stock, any gain or loss is taxed as a capital gain or loss rather than ordinary income. This is critical. Ordinary income is almost always taxed at higher rates than capital gain. You want capital gain treatment -- you pay less in taxes and keep more of your money.

If you later sell the stock but you didn't satisfy the holding-period requirements, the gain will be divided into two pieces: The spread will be ordinary income, and the amount over that will be capital gain (just like NSOs). Be diligent in keeping track of the holding period of your ISOs.

"We find that clients are often confused about the type of stock options they have and the tax treatment of each kind. They also don't realize that there can be tax implications even if the price of the stock goes down once they exercise their shares, which can be particularly disheartening," says Patte Lee, CFP and Certified Divorce Financial Analyst of Allegiant Wealth Management in Dallas.

For example, you were granted an ISO on May 12, 2012, with the option to buy 100 shares of ABC Company stock at $10 a share, which was the fair market value of the stock on May 12. You exercise the option on March 6, 2013, when the stock is trading at $12 per share. You sell the stock on March 26, 2014, for $15 per share. Let's look at the holding periods: You held the stock for more than one year, however, less than two years had elapsed from the date the stock was granted until the date it was sold. Therefore, in 2014 you must report the difference between the exercise price ($10) and the value of the stock when it was exercised ($12) as wages. The rest will be treated as capital gain.

Calculating taxes on ISOs

Sales price $15 x 100 shares = $1,500
Purchase price $10 x 100 shares = $1,000
Total increase = $500
Wages $2 x 100 shares = $200
Capital gain $3 x 100 shares = $300
Had the holding period been satisfied, the entire $500 would have been treated as capital gain.

Restricted stock

Restricted stock is a share of stock subject to certain restrictions such as the requirement that you remain employed for a period of time. When restricted stock is granted to you, the stock is issued in your name but with a legend entry reflecting the restriction. Once the restriction lapses (i.e., the stock vests), the restriction notation is removed. The fair market value of the share on the date it vests (less the amount, if any, you paid for it) is included in your wages and subject to federal income and employment taxes.

For example, you are granted 60 shares of restricted stock that vests Jan. 1, 2013. The fair market value of the stock on the day it vests is $20 per share. On that day, $1,200 will be included in your wages and subject to federal income tax at ordinary income rates and employment taxes.

It is possible to make an election to include the value of the shares on the date of grant in income. The benefit of this is that any future appreciation in the value of the stock will be taxed at capital gains rates. This election must be made within 30 days of the date of grant.

Turley says this election should be carefully considered. "Your election to accelerate the ordinary income tax associated with your restricted stock is irrevocable."

It gets complicated if, for example, your employment is terminated early or if the stock falls in value before the restrictions placed on the stock lapse. "You will have paid taxes on amounts that you may never receive," she says.

Restricted stock units

Restricted stock units are a tad more complicated. RSUs are a promise to pay cash or stock at a future date. Each unit is based on the value of a share of stock. RSUs can be paid, either in shares or in cash, on a date later than the vesting date. The federal income tax event will occur on the date the cash is paid or the stock is transferred. However, employment taxes (Social Security and Medicare) are due on the vesting date.

Due to special rules that apply to nonqualified deferred compensation arrangements, says Wilkerson, "Payments made too early or too late could subject you, as the award holder, to significant adverse tax consequences."

Assume the RSUs are granted to you Jan. 1, 2012, and they fully vest if you remain employed through Jan. 1, 2016, but with a payment date of Jan. 1, 2017. You will be paid, either in cash or shares of stock, on Jan. 1, 2017. On Jan. 1, 2016, you will owe employment taxes on the fair market value of the cash or stock in which you were vested. On Jan. 1, 2017, you will include the fair market value of the cash or stock you are paid for federal income tax purposes.

Options, restricted stock and RSUs are beneficial, but each type is subject to different tax treatment. After you finish celebrating your award of equity-based compensation, make sure you understand how it works. You want to minimize the tax burden and keep as much of your hard-earned compensation as possible.

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