

# BROWN CPA GROUP, LTD.

CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS

January 30, 2006

Dear Clients & Friends,

Some employers are still granting stock options to employees as part of their compensation packages. From a tax standpoint, there are two kinds of options- statutory and non-statutory. "Incentive stock options," or ISOs, as they are commonly known, are statutory options, because they are specifically provided for in the Internal Revenue Code and are subject to numerous qualification requirements. Options that don't meet these requirements are non-statutory stock options, or NSOs, also known as non-qualified stock options, or NQSOs. Both kinds of options have tax advantages, but there are quite a few differences between them. Here's some basic information on the taxation of compensatory stock options that may help you better understand how best to benefit from them.

**Option Grant.** If you have ISOs, then you are *not* taxed on option grant. If you have NSOs, then you are taxed on option grant only if the options have a "readily ascertainable" fair market value (FMV) at grant, which is seldom the case. IRS rules say that an option doesn't have a readily ascertainable value at grant unless: (i) the option is actively traded or immediately transferable; (ii) the option is fully exercisable; (iii) the option and the option stock are unrestricted; and (iv) in the case on a non-actively traded option, the value of the "option privilege" is readily ascertainable. In the unlikely event that an NSO is taxable at grant, you have compensation income at that point.

The deferred compensation rules under IRC 409A-which include deferred compensation in income to the extent not subject to a "substantial risk of forfeiture"-do not apply to the grant of an ISO. However, these rules can apply to the grant of an NSO, unless the exercise price can never be less than the underlying stock's FMV on the date the option is granted and certain other conditions are met.

**Option Exercise.** No regular income tax is owed on the exercise of an ISO. Tax isn't owed until the stock is sold. For stock acquired under options exercised after October 22, 2004, any remuneration that arises when stock is transferred on the exercise of an ISO is not subject to FICA or FUTA taxation.

By January 31 following the close of the year in which you exercise an ISO, your employer is required to provide you with a written or, if you consent, an electronic statement containing information about the stock that you received when you exercised your ISO. This information will include the date that the ISO was granted, the date when the stock was transferred to you, the number of shares that were transferred, and the stock's FMV at the time the ISO was exercised. From this information, we will be able to determine how long you need to hold the stock to qualify for favorable long-term capital gain rates on the difference between the price you paid for the stock and the amount you realize on its sale (see below) or, if you do not hold the stock long enough for this favorable tax treatment, how much additional compensation income will be attributed to you from the ISO exercise.

When you exercise an NSO that wasn't taxed at grant, you're subject at exercise to tax at ordinary income rates on the difference between the value of the option stock at the time and the price you paid for it (plus any price you may have paid for the option, although generally that will be zero). This is compensation income that is subject to payroll taxes and income tax withholding. Taxes may be withheld from your salary or other compensation income, or you may have to sell some of the stock to cover the withholding or make some other arrangements with your employer. However, if the option stock is non-transferable or subject to a substantial risk of forfeiture, then you aren't charged with compensation income until those restrictions no longer exist. In that case, you can choose to pay tax on exercise so that all gain from that point on would be capital gain.

**Sale of Option Stock.** When you sell ISO stock, you generally are taxed at favorable long-term capital gain rates on the difference between the price you paid for the stock and the amount you realize on its sale. However, if you sell the stock within two years of the option grant or within one year of the option exercise, you're hit with compensation income to the extent of your bargain element at exercise. The balance of your gain is capital gain, which will be taxed at favorable rates if you've held the stock for more than one year on the sale date.

For stock acquired under options exercised after October 22, 2004, any remuneration that arises when stock is transferred on the disposition of the stock is not subject to FICA or FUTA taxation. Additionally, any income resulting from a disqualifying disposition of stock acquired under an ISO is not subject to withholding.

When you sell stock acquired by exercise of an NSO, you have capital gain if you were subject to tax either at option grant or exercise, or when restrictions on your option stock lapsed. Otherwise, you have compensation income at the time of the sale.

As you can see, the tax rules for compensatory stock options are quite complex. Please call for an appointment if you have additional questions about your options, or if you would like to do some tax planning for them.

Sincerely,

*Brown CPA Group, Ltd.*

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Certified Public Accountants

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