StatonWalsh
Financial Clarity Through Transparency

Prepared for:

Prepared by:

Ryan Staton, MBA, AIF
Managing Partner
StatonWalsh
Phone: 410-777-9487
Email: rstaton@statonwalsh.com
Website: www.statonwalsh.com
December 31, 2021

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Non-Statutory Stock Option

In general terms, a stock option is the right to purchase shares in a corporation at a specified price (the "exercise" price), within a fixed period of time. Under federal income tax law,[1] a "statutory" stock option is one that qualifies as an "incentive stock option" or that is granted under an employee stock purchase plan.

An option that does not qualify as a "statutory" stock option, and that is issued in conjunction with the performance of services, is considered a "non-statutory" stock option.[2] There are few regulatory restrictions with regard to the design of non-statutory stock option plans. A corporation can pick and choose which employees or independent contractors to benefit and the terms and conditions under which the options are granted can vary from one individual (or group of individuals) to the next. Non-statutory stock options are frequently used in larger, publicly-held corporations, as a way to attract and retain key employees and executives.

Federal Income Taxation Of Non-Statutory Stock Options

The tax treatment of non-statutory stock options generally depends on whether or not there is a "readily ascertainable fair market value" on the date the option is granted.

- **Readily ascertainable fair market value:** Generally, an option is considered to have a readily ascertainable fair market value if it is (1) traded on an established market, or (2) its fair market value can be otherwise measured with reasonable accuracy.[3] If either of these standards is met, the person receiving the option (the optionee) must include the fair market value of the option in income in the year the option is granted.
- **No readily ascertainable value:** If a stock option is not considered to have a readily ascertainable market value, there is generally no federal income tax impact until the option is exercised or otherwise transferred.

Options With A Readily Ascertainable Fair Market Value

If an option has a readily ascertainable fair market value on the date of grant, the optionee must include in income in the same year the fair market value of the option, less any amount

[1] The discussion here concerns federal income tax law. State or local income tax law may differ.

[2] Non-statutory stock options are also called "non-qualified" stock options.

[3] IRC Reg. 1.83-7(b)(2) lists a series of tests to determine the fair market value of the option under this alternative method.

he or she pays for the option (typically zero). The corporation treats an equivalent dollar amount as deductible "compensation," subject to FICA, FUTA, and wage withholding:

- **Example 1:** Harry is an employee of XYZ Corp. Harry was recently granted an option to buy 100 shares of XYZ stock at $10 per share. XYZ options are traded on an established market and, on the day of the grant, had a value of $15 per share. Harry must include $1,500 ($15 per share x 100 shares) in his income this year as additional compensation. XYZ Corp. is allowed a business deduction for the amount included in Harry's income; Harry's W-2 will show an additional $1,500 of compensation, less employment taxes and normal income tax withholding.
- **If the option lapses:** If an option expires without being exercised, the optionee has a capital loss on the date of expiration, generally equal to his or her basis[1] in the option. Depending on how long the option was held, the loss can be either short-term or long-term.
  - **Example 2:** Because of a prolonged stock market decline, Sally allows an option to purchase 100 shares of her employer's stock to expire. At the time the option was granted two years ago, Sally was required to include $1,000 in income as additional compensation. On her income tax return for the year the option expires, Sally may claim a $1,000 long-term capital loss.
- **Sale of the option:** If an optionee chooses to sell an option without exercising it, the transaction is treated as the sale of a capital asset, with the holding period measured from the date the option was granted to the date of sale.
  - **Example 3:** George is an independent contractor who has done consulting work for ABC Corp. Two years ago George was granted an option to purchase 100 shares of ABC Corp. stock, at $20 per share. ABC options are traded on an established market and, on the day of the grant, had a value of $10 per share. In the year the option was granted, George was required to include in income an additional $1,000 ($10 per share x 100 shares). However, because business has been slow lately, George decides to sell his option, at the current market price of $15 per share. On his income tax return for the year of the sale, George will treat the transaction as a long-term capital gain of $500, the $1,500 sales proceeds, less $1,000, his basis in the option.

[1] Typically, the amount included in income at the time the option was granted. If the optionee paid any additional money for the option, the extra amount would also be included in basis.

- **Exercising the option:** An optionee can also choose to exercise the option, and purchase the underlying stock. For federal income tax purposes, the stock acquired through exercise of the option is treated as a capital asset.

    - **Example 4:** Two years ago, Susan was given an option to purchase 100 shares of her employer's stock at $10 per share. At the time the option was granted, the option had a fair market value of $10 per share. On her income tax return for that year, Susan was required to include an additional $1,000 in income ($10 per share x 100 shares). This year, when the stock was trading at $25 per share, Susan exercises the option and purchases 100 shares. Susan's basis in the stock is $2,000, calculated as follows: $1,000, the amount previously included in income, plus $1,000, the cost to exercise the option this year ($10 per share x 100 shares).

    Susan's holding period in the stock begins the day after she exercises her option. If she waits more than one year before selling the stock, and then sells it for $30 per share, she will have a long-term capital gain of $1,000; the $3,000 sales proceeds, minus her basis of $2,000.

- **At death:** Because the option is taxed at grant, there is no special tax treatment if an optionee dies holding either an un-exercised option, or the underlying stock. The optionee's heirs generally take the asset at FMV on the date of death. Any subsequent sale or transfer is treated in the same manner as with any other investment property.

Options Without A Readily Ascertainable Fair Market Value

If an option does not have a readily ascertainable fair market value on the grant date, there is generally no taxable event until it is either exercised, sold, or otherwise transferred. In the tax year that the optionee recognizes income, the corporation treats an equivalent dollar amount as deductible "compensation," subject to FICA, FUTA, and wage withholding.

- **If the option lapses:** If the optionee allows the option to expire unexercised, there is generally no loss for income tax purposes.

    - **Example 5:** Five years ago, Bob was granted an option by his employer to buy 100 shares of the employer's stock at $10 per share. In that year Bob was not required to include any additional compensation in his gross income as a result of being granted the option. Since then the stock has steadily declined in value. This year the option expired, unexercised. Bob has no deductible loss as a result of the option expiration.

- **Sale of the option in an "arms-length" transaction:** If the optionee chooses to sell or otherwise dispose of the option, the income tax treatment is generally determined by whether or not the sale or disposition is in an "arms-length"[1] transaction. Such a sale will result in compensation to the optionee to the extent that the sales proceeds exceed any amount paid for the option.

  - **Example 6:** Barbara, an employee of EFG Corp., is granted an option to buy 100 shares of EFG Corp. stock at $20 per share. Barbara pays nothing for the option. Six months later, Barbara decides to sell her option to an unrelated third party in an arms-length transaction, at $25 per share. For the year of sale, Barbara must include $2,500 in gross income, the amount realized from the sale ($25 per share x 100 shares), less the price paid for the option (zero).

- **Sale of the option to a related party:** The sale or other disposition of the option to a "related party"[2] is treated as if it were done in a "non-arms-length" transaction.[3] In this situation, the optionee must include in income in the year of transfer any money or property received. When the transferee (the party purchasing the option) ultimately exercises the option, the optionee must also include in gross income the excess of the fair market value of the stock acquired by the transferee over the sum of the exercise price paid and any amount included in income at the time the option was transferred.

  - **Example 7:** Five years ago, Bill was granted an option by his employer to purchase 100 shares of the employer's stock, at $25 per share. Last year, Bill sold the option to his wife, for $10 per share, or $1,000. On last year's income tax return, Bill included $1,000 as additional compensation. This year, when the stock was trading at $50 per share, Bill's wife exercised the option and purchased the stock. Bill is required to include an additional $1,500 in gross income this year, the difference between the fair market value of the stock $5,000 ($50 per share x 100 shares) less the sum of the exercise price, $2,500 ($25 per share x 100 shares) plus the $1,000 Bill included in income last year.

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[1] Generally, "arms length" refers to a sale or transfer to someone who is not related to the optionee.

[2] See IRS Reg. 1.83-7(a) for a definition of "related party."

[3] In some situations, non-arms-length transactions may be challenged by the IRS. See IRS Notice 2003-47.

- **Exercising the option:** At exercise, the optionee will generally recognize income to the extent that the fair market value of the stock exceeds the exercise price
  - **Example 8:** 18 months ago, Michael was granted a stock option by his employer to buy 200 shares of the employer's stock at $20 per share. This year, he purchased the stock when the shares were trading at $40 per share. On his income tax return for this year, Michael must include $4,000 as additional compensation, the difference between the market price of the stock at the time of his purchase, $8,000 ($40 per share x 200 shares) and the exercise price he paid, $4,000 ($20 per share x 200 shares).
- **Taxation at sale:** An optionee's basis in stock acquired through the exercise of a non-statutory stock option is equal to the exercise price plus the amount the optionee was required to include in income as a result of exercising the option. The optionee's holding period begins on the day after the stock is acquired.
  - **Example 9:** Continuing with Example 8, Michael's basis in his employer's stock is $8,000, the sum of the exercise price, $4,000, and the $4,000 that Michael was required to include in income as a result of exercising the option. If he holds the stock for more than a year, and then sells all 200 shares for a total sales price of $10,000, he will have, in the year of sale, a long-term capital gain of $2,000.
- **At death:** If an optionee dies holding an un-exercised stock option that was not taxed at the time of grant, any income or gain realized by the optionee's heirs by selling or otherwise disposing of the option is treated as income in respect of a decedent.

Restricted Property

If an individual receives stock or other property that has restrictions that affect its value, the individual does not include the value of the property in income until it has been "substantially vested." Property becomes substantially vested when it is:

- **Transferrable:** the owner can sell, gift, pledge or otherwise dispose of it; and
- **No substantial risk of forfeiture:** there is no good risk that the property will be taken away or lost.

In general, in the year that property becomes substantially vested, it must be included in income at its fair market value, less any amount paid for it.

Alternatively, an individual may elect, under IRC Sec. 83(b), to include the value of restricted property in income at the time of transfer. The election must be made within 30 days of receiving the property. With regard to non-statutory stock options, such an election is usually made when the amount that must be included in income is relatively low; any later appreciation would not be included in income as "compensation." The individual's basis for gain or loss would include the amount paid for it plus any amount included in income as compensation.

IRC Sec. 409A – Nonqualified Deferred Compensation

IRC Sec. 409A concerns the federal income tax treatment of nonqualified deferred compensation plans. Under such plans, an employee enters into an agreement with the employer to defer a portion of his or her compensation until a future date or event. If the requirements of IRC Sec. 409A are not met, all current and past-deferred compensation amounts, plus any earnings, are included in the employee's gross income for the current tax year. An additional 20% tax is levied, plus an underpayment interest penalty.[1]

In some situations, non-statutory stock options could be considered deferred compensation. To avoid having these options treated as "deferred compensation," the following rules must followed:[2]

- No option discount: The exercise price may never be less than the fair market value of the underlying stock on the date the option is granted.
- Taxation: The receipt, transfer, or exercise of the option must be subject to taxation under IRC Sec. 83.
- No deferral of compensation: The option may not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under IRC Reg. 1.83-7.

Seek Professional Guidance

Non-statutory stock options represent an opportunity to benefit, on a tax-favored basis, from the long-term growth of a corporate enterprise. However, given the complexities of income tax law, and the sometimes volatile nature of securities markets, the guidance of tax and investment professionals is strongly recommended.

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[1] Interest is charged at the underpayment rate plus 1%.

[2] See IRS Notice 2005-1.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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