Order Code RS20874
Updated January 30, 2003

Taxes and Incentive Stock Options

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Summary

Cases of individuals who have incurred large tax liabilities from the exercise of stock options and who, because of falling stock prices, had no earnings have caused some concern. This effect arises from the impact of the alternative minimum tax (AMT). There are a variety of potential legislative remedies that could be considered to rectify this problem. This report will be updated to reflect legislative developments.

During the 107th Congress, the issue arose of individuals with stock options who have incurred a significant tax liability from exercising their stock options but who have not sold their stocks and might recognize relatively small returns from selling. An article in the *Washington Post* highlighted a number of cases of individuals who owed large tax liabilities on stock that had not earned them any return.[1] This outcome may arise from lack of taxpayer awareness of the treatment of a certain class of options (statutory options) under the alternative minimum tax (AMT) which in combination with other rules can cause a large tax liability that cannot be offset with an offsetting loss when the stock price falls.[2]

A stock option confers a future right to purchase stock at a stated price. A stock option has value even if the right to purchase it is set at the current price, because purchase can be delayed and the stock may rise in value. Stock options can result in tax consequences that depend on the type of stock options: qualified (statutory) and non-qualified.

[1] "Some Shocked at Tax Bills on Options," by Carrie Johnson, *Washington Post*, March 16, 2001, p. E1.

[2] Another issue that had been raised about statutory stock options is whether the IRS would require employers to withhold income and social security taxes on exercise or disposition. The social security tax issue was less important when there was a ceiling on medicare taxes and when options tended to be confined largely to higher income individuals. This issue was settled temporarily when the IRS issued ruling 2001-14 on February 5, 2001, indicating that no withholding would be imposed before 2003; on June 25, 2002, the IRS indicated that it decided to abandon proposals to withhold these taxes.

Non-Qualified Options (NQSOs)

There are three stages to a stock option: when the option is granted (or given to the employee), when the option is exercised (when the employee purchases the stock), and when the stock is sold by the employee. For example, consider a stock that is currently worth $50; the firm can grant the individual the option to purchase stock at that price any time in the future. The option has some value because the individual can wait to see if the stock price rises before purchasing. Suppose the stock rises to $100 and the employee exercises his option. He can buy stock worth $100 for $50. (If the stock price fell, he would obviously not exercise the option). Finally, he can sell the stock, at that point, or in the future, perhaps when the stock has risen further.

Non-qualified options can, in theory, result in taxation when granted, but in practice most stock options are not traded in a market where value can be established. Otherwise, the value of the stock option (the market value minus purchase price) is taxed as ordinary income in the year the exercise takes place (and the firm deducts the cost at the same time). For example, if the option price is $50 and the market value is $100, $50 ($100 minus $50) is subject to tax. The firm, however, also deducts the $50, so that the consequence for tax revenues is the same as that which would occur if the firm simply paid wages and the employee used the wages to purchase stock. Any future appreciation in value is taxed at the lower capital gains rate (if held for at least a year). For example, if the stock price rises to $150 after a year and the employee sells, he will have a $50 long term gain ($150 minus $100), taxed at a maximum rate of 20%, which would be below ordinary rates. But he could have obtained the same tax effect by selling and repurchasing the stock on the same day as the exercise. Essentially, the only potential tax advantage associated with a non-qualified stock is that the value of the option is not usually taxed when the option is granted and taxes are delayed.

Qualified (Statutory) Options and Incentive Stock Options (ISOs)

Qualified stock options receive more favorable treatment for the individual but not for the firm, and are attractive to new firms in part for that reason. There are two forms of qualified stock options: stock purchase plans that allow all qualified employees to purchase stock at a discount, and incentive stock options which specify certain individuals as eligible. The latter is often used as a method of attracting talented individuals and giving them a performance incentive. The issues discussed here relate largely to incentive stock options.

Incentive stock options are subject to a variety of rules and restrictions,[3] among them the requirement that options be granted at fair market value. Qualified options are not subject to tax when exercised and qualify for lower capital gains tax rates if held for a year. Since the option is granted at the current fair market value, any difference between purchase price and sales price when sold is taxed at lower capital gains tax rates. (For

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[3] For example, the plan must be approved by stockholders and the employee who receives the options cannot own more than 10% of voting stock. Options cannot be traded.

individuals in the 28% bracket and higher, gains are taxed at a 20% rate, while ordinary tax rates can be as high as 39.6%.) The firm, however, cannot deduct these costs. For start-up firms that expect to have a long delay before taxes are due, this disallowance of the deduction may be unimportant. Qualified stock options, to retain their benefits, cannot be sold within 2 years of granting and one year of exercise. If they are sold prematurely, ordinary tax rates apply. Thus, in general, the best approach is to hold on to stocks at least long enough to qualify for capital gains rates.

If the price starts to fall and an individual decides to sell his stock before the required holding periods expire, this sale triggers ordinary tax treatment in the year of the sale.[4] However, there is a tax rule that allows the gain to be based on the lower of fair market value at sale or value at time of exercise. Thus if the value of the stock fell from $100 to $60, the individual who exercised options at $50 would pay a tax at ordinary rates on the difference between $60 and $50 if he sold the stock at $60, even though the difference at the time of exercise was the difference between $100 and $50.[5] This rule means that the income will always reflect the difference between option price and actual sales price no matter when the stock is sold.

ISOs and the AMT

Qualified stock options are included in the alternative minimum tax. If an individual has very large earnings from the exercise of stock options, this treatment can push him into the minimum tax and a large liability can accrue under the minimum tax the year the option is exercised. Since the minimum tax has an exemption of $45,000 for joint returns and $33,750 for singles, income in general and income due to stock options in particular must be relatively high to trigger a serious AMT consequence, however.

There is also a rule that allows valuation at the lower of market value at exercise or market value at sale, but in this case, the rule applies only if the sale and exercise occur in the same tax year. Thus it is possible to have a liability for an alternative minimum tax in one year, to have the stock fall and have no assets to pay the liability. In our previous example, if the sale did not fall into these rules, the stock would be subject to alternative minimum tax in the year exercised on the difference between $100 and $50, but a loss would be recognized for the difference between $100 and $60, a loss that could potentially be limited to $3,000 (the maximum amount that capital losses can offset ordinary income in a year). In the extreme case, consider the stock falling to zero, but valued at $100 when exercised. The individual will incur a liability under the AMT on the gain of $50 per share (after taking into account exemptions), but have no way of raising any funds to pay the tax. (The employer would not have, under current rules, withheld taxes on these amounts.)

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[4] This sale could cause him to forgo capital gains treatment if he had the stock for a year since exercise, but less than 2 years since the grant.

[5] Without this rule, income would be recognized on the difference between $100 and $50, and a capital loss for the difference between $100 and $60 would occur at the time of sale. Capital losses are subject to limits; only $3,000 per year can offset ordinary income.

There is a credit for prior year minimum taxes in excess of regular taxes that accrues when the taxpayer returns to the regular tax system. Such a credit is necessary to prevent double taxation of items, such as stock options, that reflect timing. The credit, however, is not refundable. Thus, an individual who has very high income from options relative to his ordinary income may not have enough current tax liability to absorb most of the credit. Hence, he could still be left with a very large current tax liability that can only be slowly recovered through minimum tax credits.

Part of the problem that has arisen with incentive stock options and the AMT may be that individuals were not aware of the AMT consequences and did not prepare for their tax liability by selling enough shares to be sure of being able to pay the tax and doing so within the same taxable year so as to qualify for the current fair market value rule. This lack of awareness may be the reason that similar issues do not arise with non-qualified stock options which automatically generate tax liability when exercised. It would be possible to accrue such a liability and then have your stock fall in value, generating a capital loss that is limited to offsetting $3,000 of ordinary taxable income. Incentive stock options have, however, become very popular with new, start-up, high-tech firms with employees who may be less aware of tax issues.

Possible Legislative Options

There are several possible remedies to address this problem should Congress wish to do so. More publicity about the issue may help address future problems. There are also legislative changes that could be considered. One is simply to eliminate statutory stock options from the AMT tax base. Another would be to provide an alternative valuation date for the AMT that could go beyond the tax year in which the option was exercised (as is provided in the case of non-statutory stock options), that would enable individuals who were not aware of the AMT to sell and use a lower price for purposes of the AMT, so that he or she would not be faced with a large tax bill with no means of paying it. The AMT credit could also be made refundable, although this change would be a serious departure from ordinary tax practice, or employers could be required to withhold taxes on statutory options.