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Insight

Stock Smarts: Tax Strategies for Stock Options and Restricted Stock Grants

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Silicon Valley is again abuzz with stock option fever (and the option's cousin, restricted stock units, or RSUs) due to several years of very successful local IPOs—but along with financial success often comes anxiety about taxes. This guide outlines the tax rates that apply to individuals, how different types of stock options and RSUs are taxed, and some strategies to achieve improved tax results.

Personal Tax Rates: An Overview

In general, there are four different federally imposed taxes that may impact your employee equity compensation: ordinary income tax, capital gains tax, alternative minimum tax (AMT), and the net investment income tax.

Ordinary Income Tax

Ordinary income tax refers to the tax charged on your basic income. This type of tax is as old as the IRS. Ordinary income (sometimes referred to as earned income in other parts of the tax code) includes wages, consulting fees, interest income, ordinary dividends, and net rental income.

Tax rates for ordinary income range from 10 percent at the lowest bracket to 39.6 percent at the highest. These rates apply to taxable income only, which means you first get to reduce your gross income for itemized (or standard) deductions and then a personal exemption.

To see how your deductions can impact your overall income tax rate, let's look at an example:

> A single taxpayer works for MegaTech, where she has a base salary of $180,000 and another $570,000 of income from vesting RSUs, making her total income $750,000. She doesn't own a home yet, so her itemized deductions consist of $70,000 in state income tax and $5,000 in charitable contributions. Subtracting the itemized deductions ($75,000) from her income (ignoring the itemized deduction phaseout, for the sake of simplicity) results in taxable income of $675,000 ($750,000 minus $75,000) and regular federal tax of $225,064. This means her effective tax rate (the rate after deductions) is about 30 percent ($225,064 divided by $750,000), even though her marginal tax rate on income over $400,000 is 39.6 percent.

Capital Gains Tax

Capital gains tax applies to gains from the sale of capital assets (investments). While the definition of *capital asset* can get a little complex, for our purposes it applies to all types of stock held in private or public companies.

Under the tax code, holding a capital asset for more than a year means the gain or loss on the asset's sale is considered a long-term capital gain,

and it gets taxed at a preferential rate—either 15 percent or 20 percent depending on your overall income tax bracket. Congress chose to charge a lower tax rate on long-term gains to encourage investment and capital flows to business, which help our economy.

Gains or losses on assets held less than a year are considered short-term and taxed at the taxpayer's ordinary income tax rate. So for short-term gains, you're back to federal tax rates as high as 39.6 percent. Note that capital losses can be used to offset gains, but they can only offset ordinary income up to $3,000 per year. Excess capital losses can be carried forward and applied to future tax years.

AMT

Few topics are less understood than AMT (again, that's alternative minimum tax). Our present AMT system was enacted in 1982 and basically operates to make sure higher-income earners pay at least a minimum level of tax.

The confusion over AMT lies in how the tax is computed and who should expect to pay it. Each year, when you prepare your personal income tax return, you're required to compute your tax under two methods, which we'll call the regular tax method and the AMT method. Whichever method results in the *higher* tax is the one you're required to pay.

The AMT computation starts with your taxable income before exemptions from your regular tax method, then makes a series of adjustments to arrive at your AMT income. The most common adjustments include adding back any taxes (including state income and property taxes) you deducted for regular tax and adding in the spread income from the exercise of incentive stock options (ISOs). The resulting AMT income should be much higher than your regular taxable income. As a result, when you apply the flat AMT rate of 28 percent to the higher income you derived using the AMT method, the resulting tax can be much higher than your regular tax—even though your regular tax rate can be as high as 39.6 percent.

Let's look at an example:

> Using the same numbers as in our example above, we start the AMT calculation with $675,000 of taxable income. Next, add back the deduction for $70,000 in state income taxes to arrive at $745,000 of AMT income. At that level of income, there's no AMT exemption, so your final step is to multiply the $745,000 by 28 percent, which gives us a tentative minimum tax (TMT) of $208,600. Since the regular tax of $225,064 is higher than the TMT of $208,600, the taxpayer isn't, as we say, "in AMT"—so she pays regular tax.

It takes a lot of skill and experience to accurately predict whether a taxpayer will have to pay AMT, because it depends not only on the level of income but also on the type of income as well as the mix of deductions. Later in this guide, you'll learn that being subject to AMT isn't always a bad thing; sometimes it's advantageous.

Net Investment Income Tax

The net investment income tax (NIIT) was passed under the Affordable Care Act and came into existence for the 2013 tax year. Commonly referred to as the Obamacare tax, it assesses a 3.8 percent tax on the lesser of net investment income or modified adjusted gross income (MAGI) over the applicable threshold: $200,000 for someone filing as single or $250,000 for a married couple filing jointly.

This new tax has many nuances, which we won't cover in this guide. For now, know the tax may apply to capital gains upon the sale of stock if you're already over the MAGI threshold.

State Taxes

Note we haven't addressed state taxes yet. These too impact your personal tax liability, so make sure to account for them when you create a tax strategy surrounding your stock options or RSUs.

In California, for example, state taxes are much simpler than federal taxes. At present, California doesn't distinguish between different categories of income (ordinary income, capital gains, etc.). As a result, the same rate applies to all types of

income. You can expect to pay from 9.3 percent to 13.3 percent for California state tax on all your taxable income. California does have an AMT, which operates similarly to federal tax but at a rate of 7 percent rather than 28 percent. Most taxpayers won't find themselves in California AMT unless they exercise and hold incentive stock options during the year (more on that later).

Applying the Tax Law to Common Employee Stock Situations

Now that we've discussed the four main taxes relevant to individuals, we'll explore five common tax situations that employees who work for venture-backed capital companies face.

Angel Investment or Founder Stock

For many start-up companies, the first money that comes in is from angel investors or the founders themselves in exchange for preferred and common stock, respectively.

In exchange for cash, investors (perhaps through a limited partnership) and founders receive shares of stock. The capital gains holding clock starts with the purchase of these shares, and it stops upon disposition of the stock. The shareholder realizes a long-term gain if she holds her shares for more than a year and a short-term gain if she holds it for less. While it's beyond the scope of this guide, your capital gains tax may be reduced if the investment is considered qualified small business stock.

Private Company Stock Options

Employees in private companies are generally granted one of two stock options, which are taxed very differently: incentive stock options and nonqualified stock options.

Incentive Stock Options

Incentive stock options, or ISOs, are usually granted to only the earliest employees. They're called *incentive* stock options because if you hold the stock for at least two years from the date of grant and at least one year from date of exercise, you receive long-term capital gains treatment when you sell—potentially a 20 percent federal rate benefit over the highest marginal ordinary income tax rate.

Upon receipt of an ISO grant, there's no taxable event; likewise, upon exercise (purchase) there's still no taxable event for regular tax purposes. However, upon exercise you must add the spread between the strike price and the current fair market value of the stock to your income to calculate your potential AMT liability. This may or may not cause you to incur the AMT. The AMT on ISOs is sometimes called a phantom tax because you may pay tax in the year of exercise despite the fact that you didn't sell any shares or receive any cash to help pay the tax.

The good news is if you actually pay AMT as a result of the ISO exercise, your tax return will generate a tax credit, which carries forward to future tax years. In a future year when your regular tax exceeds your TMT (again, tentative minimum tax), you get to recoup the tax using this credit. The most likely time for this to happen is in the year you sell the exercised ISO shares, assuming you hold them long enough to qualify for long-term capital gains treatment.

If you decide to sell your ISOs (or if you're forced to—for example, if your company is acquired) before you've met the one- and two-year holding requirements, then you trigger a disqualifying disposition and are taxed at ordinary income rates. This can get a little tricky if your exercise and sale occur in two different tax years, but suffice it to say that the spread at time of exercise will be treated as ordinary income. This income is reported to you as extra wages in your pay stub, but it won't be subject to any withholdings.

Nonqualified Stock Options

Nonqualified stock options (NQSOs) are normally granted to later-stage and higher-ranking employees in private companies. At the time of grant, there's no taxable event, but upon exercise of the option, the spread between the strike price and the current fair market value is reported as ordinary income. It shows up in an employee's pay stub with associated income and payroll tax withholdings. If the company is still private and there's no market for the stock, the employee

may be asked to write a check to the company to cover not only the exercise price but also the tax withholdings.

If, on the other hand, you happen to be at a very early-stage start-up such that there's no spread or a minimal spread at exercise, another strategy could be to exercise your NQSOs, then hold the shares for more than a year after exercise. If you do, you receive long-term capital gains treatment on the appreciation after exercise.

Public Company Same-Day Sale of Options

For many public company employees who haven't previously exercised their options, it can make sense to do a same-day sale if there's a substantial spread between the exercise price and the current trading price of their stock. This means they effectively exercise their option and immediately sell the underlying stock in the open market, leaving them with the sale proceeds reduced by the exercise price and applicable tax withholdings.

Note that whether an ISO or an NQSO, the sale results in ordinary income. One critical difference is that NQSOs have income and payroll tax withholdings, while ISOs have neither. Therefore, employees who exercise and immediately sell ISOs may need to make a quarterly estimated tax payment on their gain in advance of their year-end tax filing.

Public Company Exercise and Sell to Cover

Instead of selling all the shares as described in the same-day sale example, some employees choose to sell only enough shares to cover the income and payroll tax withholdings, such that they're left holding a portion of the shares. The capital gains holding clock then begins on these shares, and the future appreciation is subject to either long- or short-term capital gains treatment.

Although ISOs don't have withholding requirements, some employees choose to sell a portion of their ISOs upon exercise (triggering a disqualifying disposition for that portion) so they have cash to pay the AMT when it's due. They can then hold the rest of their shares with the goal of achieving long-term capital gains treatment as described above.

Restricted Stock Units

Employees joining late-stage private companies or public companies often receive RSUs in lieu of (or in addition to) option grants. RSUs are granted with a vesting schedule, commonly four-year vesting with a one-year cliff. The value of the shares becomes taxable as ordinary income to the employee once the restrictions lapse and the shares become freely tradable.

This income is then reported in an employee's next pay stub, and associated income and payroll taxes are withheld. At that time, the employee owns the shares and can either hold them or sell them. Note that the company normally chooses to satisfy the withholding requirement by taking back a portion of the vested shares and delivering the net shares to an account controlled by the employee.

Regardless of the decision to sell or hold the net shares upon vesting, the employee has already paid ordinary income tax on the value of the shares at vesting, and only the future appreciation in the shares will be subject to short- or long-term capital gains treatment. For this reason, most employees choose to sell the shares and diversify the proceeds. If you hold the shares (and some choose to do this), it's akin to receiving a cash bonus from your company and then electing to invest the entire bonus (after taxes withheld) back into the company stock.

Tax Strategies

While definitely not comprehensive, this section explores a few of the strategies you can use to achieve better tax consequences for your stock options and restricted stock units.

What we aim to achieve through good tax planning in each of these strategies is a 20 percent improvement in your federal tax rate with as little risk as possible. This improvement represents the difference between the federal ordinary income tax rate at 39.6 percent and the long-term capital gains rate at 20 percent.

Early-Stage ISO Exercise and Hold

If you have incentive stock options at an early-stage start-up and the current stock price is equal to your option exercise price, consider exercising

your options. The only downside of doing so is potentially losing your exercise cost.

If the company is very early stage and you can afford to take the risk (that is, it represents a smaller percent of your liquid net worth), or if the price is cheap (pennies per share), then why not start the capital gains clock as soon as possible, so all the future appreciation can be taxed at long-term rates? The assumption here is that your strike price is *equal* to the current fair market value—so there's no spread and therefore no horrible phantom tax resulting from AMT.

While this simple action would seem a popular strategy, you'd be amazed at how many people never get around to executing it.

Early Exercise or 83(b) Election

Almost all stock option grants have vesting restrictions. However, many companies offer recipients the opportunity to exercise their shares before they vest. This is commonly known as the right to early exercise.

If your stock plan allows for early exercise, Section 83(b) of the Internal Revenue Code permits you to make an election to accelerate the income tax consequences of your grant to the time of exercise (rather than vesting). This starts the capital gains holding clock at your time of purchase, before vesting occurs.

As a result, the future appreciation (even that which occurs before vesting) is all subject to the capital gains rules—and potentially the preferential long-term capital gains tax rate.

Note that you must file the 83(b) election form within 30 days of exercising your unvested options to execute this strategy. Any spread between your exercise price and the value of the underlying common stock at time of grant will become taxable income to you at the time you file the 83(b) election. Another point: You can't file an 83(b) or use this strategy to improve the tax consequences of your RSUs.

Exercise and Hold to AMT Crossover

As discussed in the first section of this guide, each year you pay the higher of your regular tax and AMT. Later, we explained that upon the exercise of an ISO, you must add into your income—for purposes of the AMT calculation—the spread between your option strike price and the fair market value of your option's underlying common stock.

If we assume that, without any ISO exercises, a taxpayer's regular tax is higher than his or her AMT for a given year, then the ideal strategy would be to exercise ISOs up to the point where the AMT rises to be equal with the regular tax. This is commonly called the AMT crossover point: basically, the point beyond which you would start to pay AMT on additional ISO exercises. You can essentially start your long-term holding period for a portion of your ISO shares on a tax-free basis as long as you don't go beyond this crossover point.

To demonstrate AMT crossover, let's return to our example:

A MegaTech employee filing single has a base salary of $180,000 and another $570,000 of income from vesting RSUs, making her total income $750,000. At this point, the taxpayer shows regular tax of $225,064 and TMT of $208,600. She isn't in AMT because her regular tax exceeds her TMT by $16,464. Now let's assume this taxpayer has some old ISOs with a strike price of $1 per share and that MegaTech is trading at $60 per share. How many ISOs can she exercise without going into AMT? While the actual calculation is a little more complicated, we can simplify by taking the spread between her regular tax and TMT ($16,464) and dividing it by 28 percent (the AMT rate). That gives us $58,800, which is the amount she can still incur in income from her ISOs before she's subject to AMT. If we divide the $58,800 by $59 (the spread on the ISOs) we come up with about 996 shares. This is the approximate number of ISOs she can exercise to get to the crossover point.

Same-Day Sale and Exercise-and-Hold ISOs

Many times, the optimal strategy is to exercise ISOs up to the AMT crossover (as described above) and then exercise no more for that year. But what if you already find yourself in AMT?

In that case, you may consider a same-day sale strategy (assuming your stock is freely tradable) to increase ordinary income such that your regular tax exceeds your AMT. Once this is achieved, you can exercise ISOs back up to the AMT crossover point. You can also use NQSOs to generate the additional ordinary income needed to execute this strategy.

To see how this strategy might play out, let's continue to work with our example. Earlier, we determined that the taxpayer could exercise and hold about 996 ISOs before reaching the AMT crossover point. But what if she already exercised and held 10,000 ISOs earlier in the year, when the ISO spread was $40 per share? That would add $400,000 of AMT income, putting her deep in AMT: A 28 percent tax on $400,000 equals $112,000, so when we add that figure to the numbers in our previous example, her ordinary tax is still $225,064 but TMT has risen to $320,600.

At this point, the taxpayer has a marginal federal tax rate of 28 percent until she gets out of AMT, at which time her tax rate goes back up to 39.6 percent—a fact she can use to her advantage in tax planning.

There are a few different ways she can proceed with this situation in mind. One way might be to sell some of the shares from her ISO exercises earlier in the year. The sale triggers ordinary income and short-term capital gains, which gradually pull her out of AMT. But as long as she's still in AMT, she pays tax on that income at only the 28 percent rate. In essence, she pulls more ordinary income into the tax year she pays AMT, enjoying a lower tax rate on it than she would in a year when she's subject to the ordinary tax rate.

She can accomplish the same thing if she has NQSOs she can exercise (or if she has a spouse who can). The idea is the same: by generating more ordinary income for as long as she's in AMT, the taxpayer is taxed at 28 percent (instead of 39.6 percent).

Exercise ISOs Early in the Year

Earlier in this guide, we explained the hazards of not holding your ISOs long enough: When you fail to hold shares you received from an ISO exercise for at least two years from the date of grant and one year from the date of exercise, you trigger a disqualifying disposition, and the transaction is taxed as ordinary income.

When the exercise and the sale triggering the disqualifying disposition occur in the same tax year, you have ordinary income. That income is computed by measuring the spread on the day of exercise. If you sell the stock later in the year, you incur a short-term capital gain or loss. You don't have to pick up the AMT income from the day of exercise, because it's been disqualified before year-end.

Given this mechanism, one strategy with a publicly traded stock is to exercise your ISO early in the year, then wait until the end of the year to see if the stock price went up or down. If it went down, you sell to trigger the disqualifying disposition. This way, you don't have to pay the phantom AMT on the higher spread value. If it goes up, you continue to hold for long-term gains treatment.

To demonstrate this strategy, let's do some calculations. Assume on January 5 you exercise ISOs for TechStock.com with a strike price of $1 per share and a fair market value of $51 per share. The year's going great, but in its Q3 earnings report the company underperforms, and the stock trades down to $31 per share. Assuming you're already in AMT, if you continue to hold the stock and don't sell by year-end, you'll show an AMT liability of $14 per share (28 percent of a $50 spread) on your current-year tax return—despite the fact that the stock is now worth much less than when you exercised. So the strategy here would be to sell the stock before the end of the year, triggering a disqualifying disposition. This results in $30 of ordinary income with a corresponding tax liability of $8.40 per share. (Again, we're assuming you're still in AMT—so that's 28 percent of the $30 spread).

RSUs and AMT

While there's really nothing you can do to change the character of your RSU income upon vesting (that is, you must pay ordinary income tax), there's something you can do to lower your overall tax bill.

In many cases, your regular income tax exceeds AMT in years when significant blocks of RSUs vest because of the large ordinary income tax hit. When you aren't in AMT, there's the potential to accelerate state income tax and property tax deductions to further reduce your regular tax.

Note that because state income tax and property tax aren't deductible for AMT purposes, you don't get any additional benefit for paying more of them once you're subject to AMT. Therefore, if you'll likely be in AMT in the following year (maybe because you'll have less RSUs vesting that year) you won't get any benefit from marginal state income tax or property tax deductions paid in that year. In this case, waiting to pay your state tax until you file your return or waiting to pay the second voucher on your property taxes can cost you big time.

Let's return to our original example: We aren't in AMT because our regular tax exceeds our TMT by $16,464 at a marginal tax rate of 39.6 percent. Let's assume the taxpayer determines she'll owe another $5,000 to California when she files her state tax return in April and that no penalties will apply if she just pays it in with the return. The question becomes: Should she pay the $5,000 additional state tax by December 31 so she can deduct it on her current-year federal return, or should she wait until April and deduct it on her federal return next year? The answer is that because she isn't in AMT yet (and won't be if she adds another tax deduction of $5,000), she'll get a benefit of the additional state tax deduction this year, when she's subject to the marginal rate of 39.6 percent. Conversely, if she waits to pay until April of the next year, she may be in AMT and receive no benefit at all. Granted, 39.6 percent of $5,000 isn't a huge number—but the math works the same with much larger numbers as well.

Find a Strategy That Works for You

With high personal tax rates and more companies using stock options and RSUs, there's more incentive than ever to understand how these compensation plans are taxed. While you can't make the associated taxes go away entirely, we've demonstrated that there are some time-tested strategies you can use to reduce their bite.

It can be well worth your time to explore how to apply these strategies to your own situation, and you should seek professional help when necessary to execute them properly. To learn more about tax strategies that may suit your personal circumstances, contact your Moss Adams professional.

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