

**OVERVIEW OF FEDERAL INCOME TAX PROVISIONS
RELATING TO
EMPLOYEE STOCK OPTIONS**

Scheduled for a Hearing
Before the
SUBCOMMITTEE ON OVERSIGHT
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on October 12, 2000

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



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CONTENTS

	<u>Page</u>
INTRODUCTION	1
I. OVERVIEW OF FEDERAL INCOME TAX PROVISIONS RELATING TO EMPLOYEE STOCK OPTIONS	2
A. In General	2
B. Types of Statutory Stock Options	3
1. Employee Stock Purchase Plans	3
2. Incentive Stock Options	4
C. Nonstatutory Stock Options	5

INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on October 12, 2000, on issues relating to the impact of Federal tax law on employee stock options. This document,¹ prepared by the staff of the Joint Committee on Taxation, describes selected Federal income tax provisions that may affect employee stock options.

¹ This document may be cited as follows: Joint Committee on Taxation, *Overview of Federal Income Tax Provisions Relating to Employee Stock Options* (JCX-107-00), October 10, 2000.

**I. OVERVIEW OF FEDERAL INCOME TAX PROVISIONS
RELATING TO
EMPLOYEE STOCK OPTIONS**

A. In General

An employee stock option is the right or privilege of an individual to purchase stock from an employer by virtue of an offer of the employer, in consideration of services performed by the individual for the employer, to sell the stock at a price described in the offer. The Internal Revenue Code provides for two general types of employee stock options: options to which section 421 applies (“statutory options”) and options to which section 421 does not apply (“nonstatutory options”²). A statutory option is either an option that meets the requirements of section 422(a) (an “incentive stock option”), or an option granted pursuant to a plan that meets the requirements of section 423(a) (an “employee stock purchase plan”).

No amount is includable in the gross income of the option recipient due to the grant or exercise of a statutory option. No compensation expense deduction is allowable to the employer with respect to the grant or exercise of a statutory option. If an employee disposes of stock acquired upon exercise of a statutory option, the employee generally is taxed at capital gains rates with respect to the excess of the fair market value of the stock on the date of disposition over the option price, and no compensation expense deduction is allowable to the employer, unless the employee fails to meet a holding period requirement. The employee fails to meet this holding period requirement if the disposition occurs within 2 years after the date the option is granted or 1 year after the date the option is exercised. A disposition that occurs prior to the expiration of the applicable holding period(s) (a “disqualifying disposition”) does not qualify for capital gains treatment. In the event of a disqualifying disposition, the income attributable to the disposition is treated by the employee as income received in the taxable year in which the disposition occurs, and a corresponding deduction is allowable to the employer for the taxable year in which the disposition occurs.

The income taxation of a nonstatutory option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). Section 83 provides that the option may be either (1) currently taxable to the employee and deductible by the employer, or (2) not taxable currently to the employee and not deductible by the employer.

For purposes of the individual alternative minimum tax, the transfer of stock pursuant to an incentive stock option is treated as the transfer of stock pursuant to a nonstatutory option.

² Nonstatutory options are also referred to as “nonqualified options.”

B. Types of Statutory Options

1. Employee stock purchase plans

An employee stock purchase plan is a plan that provides for the granting of options to purchase stock in an employer corporation³ and that meets the following requirements:

- a. The plan must provide for grants of options only to employees of the employer.
- b. The plan must be approved by the shareholders of the employer within 12 months before or after the date the plan is adopted.
- c. Under the terms of the plan, no employee may receive an option grant if the employee, immediately after such grant, owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer.
- d. With limited exceptions, the terms of the plan must provide for option grants to all employees of the employer.
- e. The terms of the plan must provide to all option recipients the same rights and privileges, except that the amount of stock that an employee may purchase under an option may bear a uniform relationship to the total compensation of all employees, and the plan may provide that no employee may purchase more than a maximum amount of stock specified by the plan.
- f. The terms of the plan must provide that the option price is not less than the lesser of 85 percent of the fair market value of the stock at the time of grant or 85 percent of the fair market value of the stock at the time of exercise.
- g. The terms of the plan must provide that an option may not be exercised after the expiration of 27 months from the date of grant or, if the option price is not less than 85 percent of the fair market value of the stock at the time of exercise, 5 years from the date of grant.
- h. The terms of the plan must prohibit an option grant that would permit an employee's rights to purchase stock under all employee stock purchase plans maintained by the employer to accrue at an rate that exceeds \$25,000 of fair market value of stock, determined at the time of grant, for each calendar year in which the option is outstanding.

³ References to the stock or employees of the employer include the stock and employees of a parent or subsidiary of the employer.

- i. The terms of the plan must provide that an option is not transferable by the recipient and is exercisable during the recipient's lifetime only by the recipient.

An option granted to an employee pursuant to an employee stock purchase plan does not qualify as a statutory option unless the employee is an employee of the employer at all times during the period that begins on the date of grant and ends on the day 3 months before the date the option is exercised.

If the option price of stock acquired by an employee upon exercise of an employee stock purchase plan option is less than 100 percent of the fair market value of the stock at the time of grant, then in the event of a disposition of such stock that is not a disqualifying disposition, or in the event of the employee's death while owning such stock, the general rule applicable to statutory options concerning capital gains treatment does not apply to the entire amount of the proceeds of the disposition. The employee's gross income for the taxable year in which the disposition occurs or in which the employee dies will include as ordinary income and not as capital gain an amount equal to the lesser of (i) the excess of the fair market value of the stock at the time of the disposition or death over the option price, or (ii) the excess of the fair market value of the share at the time of grant over the option price.

Although it is not required by law, it is common for an employee stock purchase plan to provide for an employee's payment of the option price by means of accumulated payroll deductions.⁴

2. Incentive stock options

An incentive stock option is an option that provides to an employee the right to purchase stock of an employer corporation⁵ and meets the following requirements:

- a. The option is granted pursuant to a plan that describes the aggregate number of shares that may be issued under options and the employees or class of employees eligible to receive options.
- b. The option is granted pursuant to a plan that is approved by the shareholders of the employer within 12 months before or after the date the plan is adopted.
- c. The option is granted within 10 years from the earlier of date the plan is adopted or the date the plan is approved by the employer's shareholders.

⁴ Unlike elective deferrals under a section 401(k) plan, payroll deductions under an employee stock purchase plan are not made on a pre-tax basis and are not required to be held in trust.

⁵ References to the stock or employees of the employer include the stock and employees of a parent or subsidiary of the employer.

- d. The option by its terms is not exercisable after the expiration of 10 years from the date of grant (5 years in the case of an option granted to an individual who, at the time the option is granted, owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer).
- e. The option price is not less than the fair market value of the stock at the time of grant (110 percent of the fair market value in the case of an option granted to an individual who, at the time the option is granted, owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer).
- f. The option by its terms is not transferable by the recipient and is exercisable during the recipient's lifetime only by the recipient.
- g. The terms of the option must not provide that the option will not be treated an incentive stock option.

An incentive stock option granted to an employee does not qualify as a statutory option unless the employee is an employee of the employer at all times during the period that begins on the date of grant and ends on the day 3 months before the date the option is exercised. In addition, to the extent that the aggregate fair market value of stock with respect to which incentive stock options are exercisable for the first time by any individual during any calendar year (under all plans of the individual's employer) exceeds \$100,000, such options are treated as nonstatutory options.

C. Nonstatutory Options

If an individual receives a grant of a nonstatutory option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option (determined without regard to any restriction that will lapse) over the amount paid (if any) for the option is included in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or not subject to a substantial risk of forfeiture (or, if the taxpayer elects, in the taxable year in which the option is granted). No amount is includable in the gross income of the option recipient due to the exercise of the option.

If the nonstatutory option does not have a readily ascertainable fair market value at the time of grant, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option. Upon exercise of such an option, the excess of the fair market value at the time of exercise of the stock purchased upon exercise of the option over the option price is included in the recipient's gross income as ordinary income in the taxable year in which the option is exercised.

A compensation expense deduction equal to the amount of ordinary income included in the gross income of the option recipient is allowable to the employer for the taxable year of the employer in which the recipient's taxable year of inclusion ends.

If an employee sells the stock acquired upon the exercise of a nonstatutory option, the difference between the sales price for the stock and the amount previously included in income is treated as a capital gain or loss. No further deduction is allowed to the employer.