The Tax Consequences of Choice

Options, Futures, Rights & Warrants

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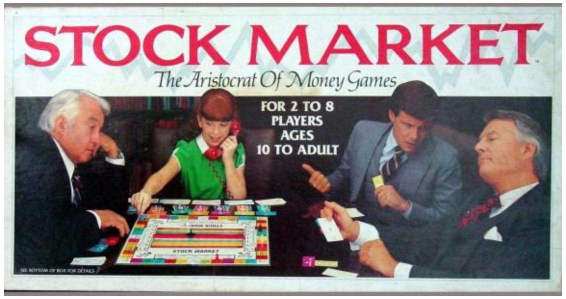
Learning Objectives

- Understand the difference between puts and calls.
- Properly report derivative securities transactions on Schedule D.
- Apply bifurcated tax treatment to §1256 regulated contracts.
- Learn the ins and outs of incentive stock, non-statutory and other employee stock options.
- Distinguish between restricted stock and restricted stock units.
- Know when to employ the IRC §83(b) or mark-to-market elections.

We'll start with…

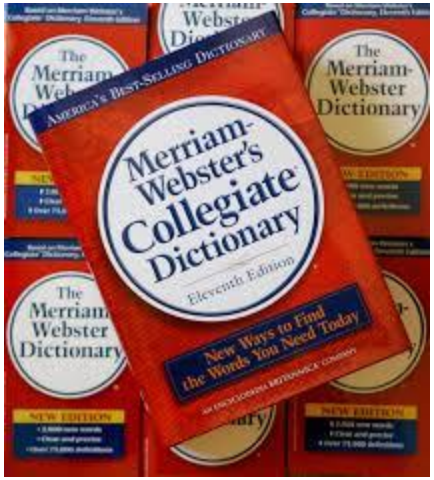
- A new language & learning the rules of the game.
- What's the best strategy to maximize gains and minimize losses?
- Moving from the game into the real world with regulated stock options.
- Getting fancy with investment alternatives.
- And, finally, back to basics with tax reporting.



op·tion [op-shuh n]

noun

1. the power or right of choosing.
2. something that may be or is chosen; choice.
3. the act of choosing.



It’s a choice

- To state your preference
- To make a selection
- To come to a decision
- To “keep your options open”
- To choose not to decide
- To accept an “option of last resort”

- Or… to be out of options!

You can't make the same mistake twice.

The second time you make it, it's no longer a mistake.

It's a choice.

An Intro to the World of Options

- Take something familiar -
  a grocery store coupon…

- Gives shopper choices:
  1. Go shopping, buy cereal, save money OR
  2. Ignore & not use coupon, buy another brand

The Players

- Always TWO players required:
  - Shopper: clips coupon to buy cereal
  - Manufacturer: issues coupon & offers cereal
- Shopper = YOU = "Holder"
  - buys the option & is "long the position"
- Issuer = KELLOGG's = "Writer"
  - sells the option & is "short the position"

**For every holder with a choice,
there is a writer with an obligation.**

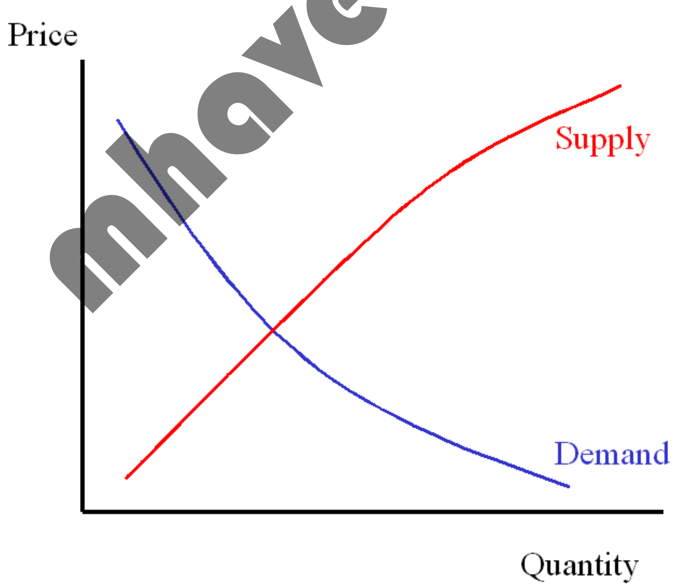
The Rules: Expiration

- Holder must decide whether to shop (or not) before coupon becomes invalid
- If date passes, holder might as well discard coupon

All options become worthless at expiration.

The Cost to Play: Premium

- Coupons (options) are not free
- Price is determined by supply & demand



Premium: Two components

1. Intrinsic Value = amount of savings the option can offer (bargain value)

   If shopper can buy cereal for $3 when price on shelf is $4 → coupon offers $1 savings

2. Time Value = time is money; if there's no time there's no value

Intrinsic value may rise & fall
but time value will always trend to zero.

Playing the Game

Cereal Shopper

- Is worried about price increases
- Wants choice to buy cereal later at guaranteed price

➔ Shopper buys time with a CALL

Kellogg's

- Is worried that future prices might drop
- Wants choice to sell cereal later at guaranteed price

➔ Kellogg's buys time with a PUT

Example # 1: Call Option

- Shopper buys CALL on corn flakes with:
  - Strike Price: Gives holder right to buy cereal at $3/box
  - Expiration: Coupon becomes worthless at year-end
  - Premium: Shopper pays $1 for the coupon
  - Market price: Cereal on the shelf currently sells for $3/box

- Coupon offers no bargain now → no intrinsic value

- But coupon locks in cereal price for the future → Shopper buys time for $1 (= insurance policy)

Example # 1

What happens if cereal price changes?

<u>Price goes ↑ to $4/box</u>

- Shopper could use coupon to buy cereal
- Break-even = $1 Premium + $3 Strike Price [same as buying cereal at market for $4]
- If cereal price goes above $4, Shopper comes out ahead!

<u>Price drops below $3/box</u>

- Shopper will forego purchase of cereal
- Forfeits cost of option [$1 premium]

Maximum Gain = unlimited
Maximum Loss = Premium
Breakeven = Strike Price + Premium

Example # 2: Put

- Kellogg's buys PUT on corn flakes with:
  - Strike Price: Gives holder right to sell cereal at $3/box
  - Expiration: Coupon becomes worthless at year-end
  - Premium: Kellogg's pays $1 for the coupon
  - Market price: Cereal on the shelf currently sells for $3/box

- Coupon offers no bargain now → no intrinsic value

- But coupon locks in cereal price for the future → Kellogg's buys time for $1 (= insurance policy)

Example # 2

What happens if cereal price changes?

<u>Price goes ↓ to $2/box</u>

- Kellogg's will use its coupon to force Shopper to buy cereal at $3
- Break-even = $3 Strike Price - $1 Premium [same as selling cereal at market for $2]
- If cereal price drops below, Kellogg's comes out ahead!

<u>Price goes above $3/box</u>

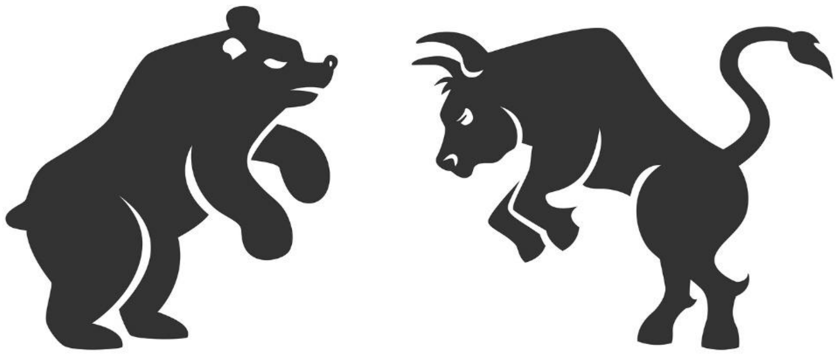
- Kellogg's will choose not to sell cereal
- cost of option [$1 premium]

Maximum Gain = $2
Maximum Loss = Premium
Breakeven = Strike Price - Premium

Bulls & Bears

- Holder of a CALL is bullish
  He wants market price to go up

- Holder of a PUT is bearish
  He wants market price to go down



Terms Reviewed

- Option is a **derivative** security that gives Holder the right to buy (or sell) an **underlying asset**
- Holder purchases the option and has the choice to **exercise**
- Writer is the **contra-party** who sells the option, collects the **premium** and is obligated to perform at Holder's whim
- A **call** gives Holder the choice to buy an asset at the **strike price** before the **expiration** date; thereby forcing Writer to sell the asset
- A **put** gives Holder the right to sell an asset before the expiration date; thereby forcing Writer to buy the asset

Options in Practice

- In 1993 Orange County, CA was worried that interest rates would fall [like Kellogg's was worried about price declines]
  → Used "derivatives" to protect the portfolio

- Alas! Federal Reserve instituted 6 consecutive rate hikes in early 1994
  → Options became worthless – **County lost all of its investment**

- And to make things worse: County used borrowed funds to increase investment potential from $7.5 to $20.5 billion but could not repay loans when options expired

- Epilogue: Interest rates turned south at mid-year but options had already expired

What's the easiest way to make a small fortune with options?

Start with a large fortune.

Regulated Stock Options

- Standardized contracts first introduced on CBOE in 1973 (911 contracts)
  - ➢ 5 billion now traded annually
    - On 10,000 companies, stock indices, exchange-traded funds & cybercurrencies
    - 4 exchanges

- Governed by Options Clearing Corp. (OCC)
  - – Founded in 1973 to promote market stability & integrity

OCC = "God"

- Selects underlying securities (equities, indexes, debts instruments & foreign currencies) based on trading volume & volatility

- Acts as contra-party to each transaction by severing relationship between holder & writer

- Establishes strike price, contract size, expiration date [max. 9 months, unless LEAPs]

- Does not set option premium (determined by supply & demand based on intrinsic & time values)

Nomenclature

- Standardized to ensure all investors know to…
  - Multiply premiums & strike prices by standard contract size of 100 shares
  - Equity options generally expire 3rd Friday of stated expiration month
  - Option was originally created 9 months before its expiration

PG111022C00060000
- Underlying Stock Symbol – 'PG' (Procter & Gamble)
- Expiration Date – '111022' (YYMMDD) or 10/22/2011
- Type of Option – 'C' or Call
- Strike Price – '00060000' (60000/1000) or $60

Sample Contract

On January 13, 20YY, investor buys a JUL 14 Call on EFG for $2.52 & pays commission [$50/trade]

- *Investor spent $252 (plus commission) on contract that allows him to buy 100 shares of EFG stock for $14/share any time between now & expiration date on July 20th, 20YY*
- *Aggregate exercise price will be $1,400*
- *If market price of EFG is currently $15.48/share, the option is <u>in-the-money</u>*
- *Option was created & first traded in October 20XX (9 months prior to expiration)*

Call Holder's Choices

1. *Exercise – use option to purchase 100 shares of EFG at $14/share*
   - → *Basis of stock = Strike Price + Premium + Commission*
   - → *$1,400 + 252 + 50 = $1,702 basis*
   - → *No taxable event until stock sold*
   - → *May result in ST or LT capital gain*

2. *Allow option to expire – do nothing and forfeit premium of $252*
   - → *Basis of option = Premium + Commission*
   - → *$252 + 50 = $302 loss*
   - → *ALWAYS capital; always ST*

Call Holder's Choices (cont'd)

3. Close Out Position – eliminate by selling option to new holder
   → Capital Gain (Loss) = Premium received – Premium paid

On April 10, 20YY, investor sells JUL 14 Call on EFG for $0.96

- *Bob pays $50 commission*
- *Bob's capital loss is computed:*

	Sales Price $96 – Commissions $50	*$46*
–	*Purchase Price $252 + Commissions $50*	*<u>302</u>*
=	*Realized Loss*	*$256*

- *Capital loss is ST (January – April)*

No tax until exercised, expired or closed, even if deferred into following year.

Call Writer's Tax Consequences

- Seller of option receives premium less commission paid for the trade
  → no immediate tax consequence since outcome unknown

- Writer has no choice and is dependent upon decision of Holder who may choose to:
  1. Exercise (writer must deliver stock) [see next slide]
  2. Expire (option becomes worthless) → Writer has ST capital gain

- Writer may close (eliminate) position by paying premium to buy option back from a 3rd party
  → Writer has ST gain (loss) = Premium received - Premium paid

Writer's Tax if Holder Exercises

Charlie sold JUL 14 Call on EFG for $2.52 (- $50 commission) to Bob & received $202 → no income recognition yet

At exercise: Charlie must deliver 100 shares of EFG; he'll receive $1,400

Charlie owns EFG [bought long ago at $13.17/sh + $50 commission]

He is "covered"

1400	*Sales Price of Stock*
– 1165	*Cost of Stock $1317 + Commission $50 – Option Income $202*
235	*Realized Gain*

Charlie doesn't own EFG & must buy at market (e.g. $16/sh)

He is "uncovered"

1400	*Sales Price of Stock*
– 1448	*Cost of Stock $1600 + Commission $50 – Option Income $202*
-48	*Realized Loss*

Summary of Tax Consequences

(*always* capital)

	Expiration	Exercise	Close Out
Call Holder [may buy stock]	STCL (= prem. out)	ST or LT after disposition of stock Basis of stock = strike + prem. out	ST* (= prem. in – prem. out)
Put Holder [may sell stock]	STCL (= prem. out)	ST or LT (= strike – basis) Basis of stock = cost + prem. Out	ST* (= prem. in – prem. out)
Call Writer [must sell stock]	STCG (= prem. in)	ST or LT (= strike – basis) Basis of stock = cost – prem. in	ST* (= prem. in – prem. out)
Put Writer [must buy stock]	STCG (= prem. in)	ST or LT after disposition of stock Basis of stock = strike – prem. in	ST* (= prem. in – prem. out)

**** LEAPS may (?) generate LT capital gains (losses) at close out.***

Options & Taxes

- Always capital → report purchase, sale or expiration on Schedule D (Form 8949)
- Always ST if option closed or expired – maximum duration is 9 months (except LEAPS)
- Holding period of option tacked on to holding period of underlying security if option exercised

Wash Sale Rule

- Purpose: To prevent claiming tax loss on illusionary sale
- Cannot re-purchase "substantially the same" security during 60-day window
- Applies to all securities, including options

Example: Wash Sale

<u>*Facts*</u>

- *Taxpayer sold stock at a loss*
- *Next day he sold (wrote) put on same stock scheduled to expire in 1 month*
- *Put was in-the-money at the time of purchase which gave Holder the right to sell stock at strike price higher than market price*

<u>*Rev. Rul. 85-87*</u>

IRS found that Holder would very likely exercise & compel Writer to buy stock

→ *Writer* ***violated Wash Sale*** *by buying substantially same security*

IRS decision based on:

- *Spread between value of underlying stock & exercise price*
- *Term of put*
- *Amount of premium paid*
- *Historic price volatility of stock*

Sample 1099

Proceeds from Broker and Barter Exchange Transactions

2019 1099-B* OMB No. 1545-0715 (continued) 02/01/2020

SHORT TERM TRANSACTIONS FOR COVERED TAX LOTS *(Lines 2 & 5)*

Report on Form 8949, Part I with Box A checked. Basis is provided to the IRS. *(Line 12)*
"Gain or loss (-)" and "Additional information" are NOT reported to the IRS.

1a- Description of property/CUSIP/Symbol

1c- Date sold or disposed	Quantity	1d- Proceeds & 6- Reported (G)ross (N)et	1b- Date acquired	1e- Cost or other basis	1f- Accrued mkt disc (D) 1g- Wash sale loss disallowed (W)	Gain or loss(-) & 7- Loss not allowed(X)	Additional information
EXTERNAL INTERNET TECHNICAL SERVICES / CUSIP: 123456789 / Symbol: EITS							
05/21/19	10,000.000	11,350.50 N	01/29/19	10,000.00	...	1,350.50	Sale Ordinary gain/loss
FIRST ANNUAL HOLDINGS / CUSIP: 123456789 / Symbol: PHYL							
03/07/19	1,000.000	84,575.00	01/15/19	96,475.00	6,500 W	-5,400.00	Merger
HOUSING INC / CUSIP: 123456789 / Symbol: HGBW							
07/01/19	15,000.000	16,350.00 N	VARIOUS	13,650.00	1,140.25 D	1,559.75	Total of 2 lots
07/01/19	7,000.000	6,630.00 N	03/15/19	7,000.00	...	-370.00	Sale Note: 26
	Security total:	22,980.00		20,650.00	1,140.25 D	1,189.75	
JULES NORHAM HOUSING SERVICES JNHS Feb 20 2019 60.0 Call / CUSIP: / Symbol: JNHS 2/20/19 C 60.0							
01/21/19	2.000	-2,764.23	N/A	...	...	...	Short sale closed-option
DOMESTIC CORPORAT DCFC Jun 19 2019 48.0 Put / CUSIP: / Symbol: DCFC 6/19/19 P 48.5							
06/24/19	5.000	509.11	06/21/19	0.00	...	509.11	Option expiration short position
TRANSATLANTIC GENE TGUK Sep 18 2019 125.0 Call / CUSIP: / Symbol: TGUK 9/18/19 C 125.0							
07/18/19	5.000	207.25	07/17/19	0.00	...	207.25	Short sale closed-option
NEUROLOGICAL OPER NOT Mar 20 2019 85.0 Put / CUSIP: / Symbol: NOT 3/20/19 P 85.0							
02/21/19	3.000	-408.68	02/20/19	0.00	...	-408.68	Short sale closed-option
	Totals:	**116,448.95**		**127,125.00**	**1,140.25 D** **6,500 W**	**-2,350.64**	

SHORT TERM TRANSACTIONS FOR NONCOVERED TAX LOTS *(Line 5)*

Report on Form 8949, Part I with Box B checked. Basis is NOT provided to the IRS. *(Line 12)*
"Date acquired," "Cost or other basis," "Adjustments & Code(s), if shown," "Gain or loss (-)" and "Additional information" are NOT reported to the IRS.

1a- Description of property/CUSIP/Symbol

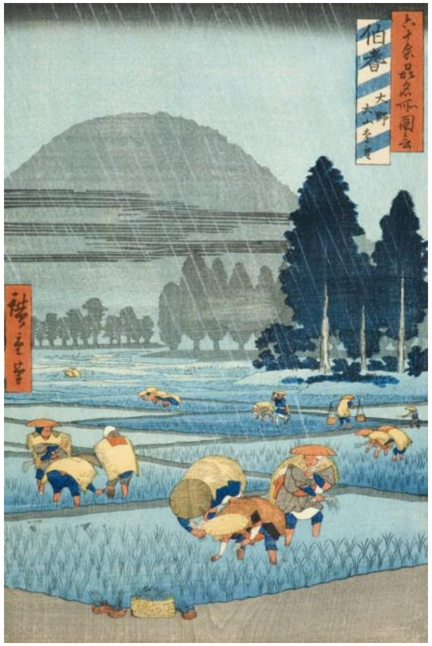
1c- Date sold or disposed	Quantity	1d- Proceeds & 6- Reported (G)ross (N)et	Date acquired	Cost or other basis	Adjustments & Code(s), if any**	Gain or loss(-) & 7- Loss not allowed(X)	Additional information
ENTERPRISE TELECOM / CUSIP: 123456789 / Symbol: ETID							
11/05/19	1,400.000	111,028.77 N	02/08/19	91,315.43	...	19,713.34	Sale Proceeds adjusted for option premium of $7,042.07
	Totals:	**111,028.77**		**91,315.43**	**...**	**19,713.34**	

* This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported. Remember, taxpayers are ultimately responsible for the accuracy of their tax return(s).

Regulated Options:

- Date of acquisition of non-covered options listed as N/A
- Position CLOSED by a covering transaction or allowed to EXPIRE
- Stock sale proceeds are reported net of option premium

Back to the Future



- Rice futures created in 17th century Japan
  - Merchants stored rice in warehouses
  - To raise cash, warehouse owners sold “rice tickets” against the stored rice
  - Tickets were traded by investors & became commercial currency
- American grain futures created in mid-19th century
- Foreign currency & index futures created in 1970s
- Index futures created in 1980s

§1256 Contracts

- Include futures, foreign currency & regulated transactions
- Often remain “open” at year-end if not yet exercised or expired
- But treated as though sold at FMV on 12/31
- Resulting gain is deemed 40% ST & 60% LT regardless of actual holding period
- Reported on Form 6781

Form **6781**
Department of the Treasury
Internal Revenue Service

Gains and Losses From Section 1256 Contracts and Straddles
► Attach to your tax return.

OMB No. 1545-0644
20
Attachment Sequence No. 82

Name(s) shown on tax return: TAXPAYER
Identifying number: 999-99-9999

Check all applicable boxes (see instructions).
A ☐ Mixed straddle election
B ☐ Straddle-by-straddle identification election
C ☐ Mixed straddle account election
D ☐ Net section 1256 contracts loss election

Part I Section 1256 Contracts Marked to Market

	(a) Identification of account		(b) (Loss)		(c) Gain
1	100 SPX JUNE 08 1250 CALLS				1,070,000
2	Add the amounts on line 1 in columns (b) and (c)	2	(0)		1,070,000
3	Net gain or (loss). Combine line 2, columns (b) and (c)			3	1,070,000
4	Form 1099-B adjustments. See instructions and attach schedule			4	
5	Combine lines 3 and 4			5	1,070,000
	Note: *If line 5 shows a net gain, skip line 6 and enter the gain on line 7. Partnerships and S corporations, see instructions.*				
6	If you have a net section 1256 contracts loss and checked box D above, enter the amount of loss to be carried back. Enter the loss as a positive number			6	
7	Combine lines 5 and 6			7	1,070,000
8	**Short-term capital gain or (loss).** Multiply line 7 by 40% (.40). Enter here and include on the appropriate line of Schedule D (see instructions) FLOWS TO SCH D LINE 4			8	428,000
9	**Long-term capital gain or (loss).** Multiply line 7 by 60% (.60). Enter here and include on the appropriate line of Schedule D (see instructions) FLOWS TO SCH D LINE 11			9	642,000

Example: §1256 Contracts

<u>Facts</u>

June 17th, 20XX: bought 100 SPX Jun 08 1250 calls for 145

December 31st, 2006: contract value = 252

<u>Mark-to-Market</u>

*Contract **deemed** sold & repurchased on 12/31/XX at 252*

***Gain**: 252 – 145 = 107 → 40% ST ($42.80) & 60% LT ($64.20)*

<u>Facts</u>

*March 12th, 20YY: Contract **actually** sold at 228*

Deemed purchase price at 252 on 12/31/XX [see above]

<u>Tax Reporting</u>

Sale	*228*
Basis	*<u>252</u>*
Loss	*(24)*

→ 40% STCL ($9.60) & 60% LTCL ($14.40)

Sample 1099

PAYER'S TIN: XX-XXXXXXX | RECIPIENT'S TIN: XXX-XX-XXXX

[ ] FATCA filing requirement (see instructions)

Summary Information

DIVIDENDS AND DISTRIBUTIONS 2019 1099-DIV* OMB No. 1545-0110

1a- Total ordinary dividends (includes lines 1b, 5)	144.48
1b- Qualified dividends	144.48
2a- Total capital gain distributions (includes lines 2b, 2c, 2d)	0.00
2b- Unrecaptured Section 1250 gain	0.00
2c- Section 1202 gain	0.00
2d- Collectibles (28%) gain	0.00
3- Nondividend distributions	0.00
4- Federal income tax withheld	**0.00**
5- Section 199A dividends	0.00
6- Investment expenses	0.00
8- Foreign country or US possession: See detail 7- Foreign tax paid:	0.00
9- Cash liquidation distributions	0.00
10- Noncash liquidation distributions	0.00
11- Exempt-interest dividends (includes line 12)	0.00
12- Specified private activity bond interest dividends (AMT)	0.00

MISCELLANEOUS INCOME 2019 1099-MISC* OMB No. 1545-0115

2- Royalties	0.00
3- Other income	500.00
4- Federal income tax withheld	**0.00**
8- Substitute payments in lieu of dividends or interest	0.00

SECTION 1256 CONTRACTS 2019 1099-B* OMB No. 1545-0715

8- Profit or (loss) realized in 2019 on closed contracts	0.00
9- Unrealized profit or (loss) on open contracts-12/31/2018	0.00
10- Unrealized profit or (loss) on open contracts-12/31/2019	0.00
11- Aggregate profit or (loss) on contracts	0.00

If applicable, proceeds from sale transactions appear summarized below and are detailed in subsequent sections of this document.

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SUMMARY OF PROCEEDS, GAINS & LOSSES, ADJUSTMENTS AND WITHHOLDING

Refer to the 1099-B and Proceeds not reported to the IRS pages to ensure that you consider all relevant items and to determine the correct gains and losses. The amounts shown below are for informational purposes.

Term	Form 8949 type	Proceeds	Cost basis	Market discount	Wash sale loss disallowed	Net gain or loss(-)
Short	A (basis reported to the IRS)	446.00	217.50	0.00	0.00	228.50
Short	B (basis not reported to the IRS)	0.00	0.00	0.00	0.00	0.00
Short	C (Form 1099-B not received)	0.00	0.00	0.00	0.00	0.00
	Total Short-term	**446.00**	**217.50**	**0.00**	**0.00**	**228.50**
Long	D (basis reported to the IRS)	37,072.50	28,413.00	0.00	6,500.00	15,159.50
Long	E (basis not reported to the IRS)	42,055.50	39,900.00	1,140.25	0.00	1,015.25
Long	F (Form 1099-B not received)	0.00	0.00	0.00	0.00	0.00
	Total Long-term	**79,128.00**	**68,313.00**	**1,140.25**	**6,500.00**	**16,174.75**
Undetermined	B or E (basis not reported to the IRS)	0.00	0.00	0.00	0.00	0.00
Undetermined	C or F (Form 1099-B not received)	0.00	0.00	0.00	0.00	0.00
	Total Undetermined-term	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**
	Grand total	**79,128.00**	**68,313.00**	**1,140.25**	**6,500.00**	**16,403.25**

Withholding	Amount
Federal income tax withheld	284.63

§1256 Contracts: Brokers must report
- profit (loss) on closed contracts
- unrealized profit (loss) at the end of the previous year
- unrealized profit (loss) for the current year
- aggregate profit (loss) amount

Commodity Futures

- Also known as “Forwards”
- Give holder right to buy oil, metals, grains & livestock
- Pricing based on supply & demand
- Automatic exercise at expiration
- Require physical delivery at expiration
- Subject to §1256 treatment

Foreign Currency Transactions

1. Regulated (governed by IRC § 1256)
   – Exchange-traded
   – Treat 40% ST & 60% LT capital regardless of actual holding
   – Report on Form 6781

2. Non-regulated (governed by IRC § 988)
   – Cash forex & interbank trades
   – Gains & losses treated as ordinary
   – Losses not limited by $3K rule
   – Not subject to Wash Sale Rule
   – Report as Other Income on Form 1040

NOTE: Taxpayer may elect § 1256 treatment on a trade-by-trade basis [best if transaction results in taxable gain]

October. This is one of the worst months to invest in stocks.

The others are July, January, September, April,
November, May, March, June, December,
August and February.

- Mark Twain

Rights & Warrants

- Often given to existing shareholders when company seeks to raise additional capital

- Grant opportunity to purchase new issue at discounted price prior to public offering

- Holders have <u>option</u> to:
  - exercise & purchase new shares
  - close out position by selling rights to 3rd party
  - forfeit option & allow rights to expire

Rights vs. Warrants

<u>Rights</u>

- Typically short-term (30 – 60 days)
- Attached to original share of stock
- May be detached
- Strike Price is always below current market price of stock

<u>Warrants</u>

- Usually attached to bonds as incentive to purchase corporate debt
- Grant opportunity to obtain an equity (growth) position
- Often long-term with expiration of 6 months to a year (or more)
- Strike price is always set above current market price to discourage immediate exercise

Tax Consequences if Detached

- No tax consequence at time of receipt

- Investor may allocate a portion of original stock's basis to right or warrant & use it to calculate gain (loss) if position sold

Investor bought 200 shares of XYZ at $2,000 & received 20 rights to purchase an additional 20 shares at $3/share. On the date of distribution, the stock is worth $1,900 and the rights are worth $80…

Basis is allocated as follows:

  - *Basis of Stock = $1900 ÷ ($1900 + $80) × $2000 = $1919*
  - *Basis of Rights = ($80 ÷ $1980) × $2000 = $81*

- Holding period of original stock or bond is tacked on to holding period of right or warrant

Tax Consequences if Exercised

- No tax consequence at time of receipt or exercise
- Basis of newly acquired shares = Strike Price + allocated basis of right or warrant
- Holding period of stock begins day after exercise

Tax Consequence if Expired

Depends whether right or warrant was issued to investor or acquired in secondary market

<u>If issued to Investor</u>

- No tax consequence
- Allocated basis of right or warrants reverts to basis of stock or bond to which it was attached

<u>If acquired by Investor</u>

- Capital loss = Premium paid to purchase right or warrant
- Holding period begins at acquisition

Summary: Rights & Warrants

	Tax Consequence	Basis	Holding Period
Exercise [Stock is acquired using Right (R) or Warrant (W)]	No gain (loss) on R or W	Basis of Stock = Purchase Price of Stock at Strike Price + Allocated Basis of R or W	Begins on day after exercise (does not include pre-exercise period)
Sale of Detached R or W	Gain (loss) = Sale Price – Allocated Basis of R or W	Allocated Basis	Includes holding period of Stock to which R or W had been attached
Expiration [R or W is allowed to lapse]	If acquired on 2° market, then realized loss If received from Company at issuance, no gain (loss)	Purchase Price of R or W Allocated basis reverts to original Stock	Begins on date of acquisition of R or W N/A


ESOP
Employee stock ownership plans

Employee Stock Option Plans (ESOPs)

- Employer grants its employees the right to purchase company shares
  - Used to motivate employees
  - No cost to employer

- FMV of option – determined based on complex formula – may be deducted by issuing company

- Two types:
  1. Statutory: ISOs & ESPPs
  2. Non-statutory

Incentive Stock Options (ISOs)

Granted to key employees

- Max. annual limit = $100K/employee
- Must be exercised within 10 years

<u>Tax Consequences</u>

1. Regular Tax: No inc recognition when granted or exercised; inc recognized when stock sold
   a. LT gain (loss) if held > 1 yr after exercise <u>and</u> held > 2 yr after grant
      → Basis of stock = Exercise price

   b. Ordinary inc if disqualifying disposition *before* holding periods met [rprted W-2, Box 1]
      → Basis of stock = Exercise price + compensation recognized

2. Alternative Minimum Tax
   Bargain element = tax preference item
   FMV_{stock} – Strike $Price_{option}$ [reported W-2, Box 14]

Example: ISO

Holding periods *not* met

2/15/XX: JKL granted ISO to buy 100 shares at $10/sh
10/1/ZZ: Employee exercised when FMV of stock was $15/sh
11/1/ZZ: Employee sold stock for $16/sh

2-yr holding period met
1-yr holding period not met

→ W-2 inclusion in 20ZZ = $500 (1500 - 1000)
→ Form 1099-B issued for $1,600 sales proceeds
→ Basis of stock = $1500 (1000 + 500 compensation recognized)
→ STCG = $100 (1600 – 1500).

If holding requirements had been met…

- No compensation recognized
- LTCG = $600 (1600 – 1000) when stock sold at $16/sh

ISOs & AMT

Bargain element is tax preference item

- Income recognized can be added to AMT basis
- AMT gain < regular gain in year of sale

Example

Using ISO, Taxpayer paid $128K to buy stock worth $4.5 million

→ Huge AMT liability on bargain element

Taxpayer later sold stock for $1.7 million

→ Economic gain = $1.7 million – $128K

→ AMT tax loss = $1.7 million – $4.5 million

→ Subject to $3K/year limitation on capital losses!!!

(No AMT NOL carry-back allowed)

MTC to the Rescue!

Minimum Tax Credit

- Generated by AMT but can be used to reduce Regular Tax
- Non-refundable (pre-2007): "Bail-out Bill" abated tax under-payment attributable to AMT adjustment for ISOs
- Refundable (2007 – 2012): Could use credit from year of exercise to reduce regular tax liability in year of sale
- Carry-forward (2013 – present): Excess credit can no longer generate a tax refund

ISO: Tax Planning

- Limit number of ISOs exercised annually to avoid triggering AMT
- Exercise ISOs early in year & then monitor stock price…
  - If stock price ⇩, sell shares
    → disqualifying disposition but no AMT preference item & no AMT on phantom income
  - If stock price ⇧, hold shares
    → pay AMT on phantom income but actual income will eventually be realized when stock is sold

Employee Stock Purchase Plans

ESPPs: Must be exercised within 5 years after grant if strike price ≥ 85% of market price

- No income recognized at grant or exercise
- No AMT adjustments
- If stock held > 1 year after exercise and held > 2 years after grant, gain (loss) will be LT

Example of ESPP

Holding Periods *not* Met

2/15/XX: JKL granted ISO to buy 100 shares at $10/sh
when stock at $12/sh
10/1/ZZ: Employee exercised when FMV of stock was $15/sh
11/1/ZZ: Employee sold stock for $16/sh

2-yr holding period met

1-yr holding period not met

→ Ordinary income $500 (= 1500 – 1000)
→ STCG $100 (= 1600 – 1500)

If holding periods met…
→ *Ordinary income $200 (= 1200 – 1000)*
→ *LTCG $400 (= 1600 – 1200)*

If stock sold at $7/sh
→ *LTCL $300 (= 1000 – 700)*

Non-qualified Stock Options

- NQSOs taxed as compensation:
  - On grant date if readily determinable value, or
  - Income recognition postponed until exercise or transfer if no value available

  NOTE: Often creates Income-in-Respect-of-Decedent (IRD) if employee dies before exercise

- Income = Value of option – price paid for option (if any)
  [reported W-2, Box 1]

- Basis of stock = Price paid for option (if any) + compensation recognized

Example

Zuckerberg (Facebook) exercised option to buy 60 million shares

→ *taxed as compensation income ($2.3 billion) on date of exercise*

→ *tax liability > $1.1 billion*

→ *forced to sell 30.2 million shares to cover tax on stock-option purchase*

Rule No. 1: Never lose money.

Rule No. 2: Never forget rule No. 1.

- Warren Buffett

Restricted Stock

Given to employee at no cost; subject to forfeiture for several years

<u>Income Recognition</u>

- General Rule
  - No recognition until vested or restriction lapses
  - Income = Amount paid for stock – FMV at vesting
  - Income & employment taxes are withheld in year vested

- IRC §83(b) election
  - Recognize income upon receipt of stock
  - Employee recognizes compensation income on date of transfer
  - BUT receives no cash with which to pay tax
  - Any FMV ⇧ taxed as capital gain when stock sold
  - Holding period begins on date of transfer

§83(b): Pros & Cons

- Elect when:
  - Shares have low value on date of award
  - Employee pays (near) full value for stock
  - Expect significant price appreciation of stock

- Do *not* elect if:
  - Employee would be required to recognize substantial income on date of award
  - Employee unlikely to satisfy terms of non-forfeiture

Example: Restricted Stock

Facts

Employee is granted 1,000 shares when FMV of stock @ $10/sh

Granted shares vest 3 years later when FMV @ $40/sh

Stock sold immediately after vesting @ $40/sh

Employee is in 37% tax bracket (20% cap gains rate)

	Without §83(b) Election	With §83(b) Election
Compensation on Grant Date **1,000 sh X $10/sh**	0	10,000
Compensation at Vesting **1,000 sh X $40/sh**	40,000 (ordinary income)	0
Gain on Sale **$40,000 Sales P - Basis**	0	30,000 (LTCG)
Total Tax Liability **37% (20%) on Compensation (Gain)**	14,800	3,700 ord + 6,000 cap gain
Net After-tax Proceeds **$40,000 Sales P – Tax Liability**	25,200	30,300

Restricted Stock Units

RSUs are similar to restricted stock EXCEPT:

- Fewer restrictions
- No stock shares issued; no dividends paid; no voting rights
- Cannot make §83(b) election

Tax Treatment

- No income inclusion at time of award
- Include compensation income when shares are received [reported on W-2, Box 1]
- Capital gain when shares are sold

  BEWARE: Basis on 1099 probably incorrect; check employee's paystub for amount of compensation reported at time of award

TCJA Changes

- Employees of certain privately held companies can elect to defer NQSO & RSU income for up to 5 years
- Corporations can no longer deduct more then $1 million of restricted stock & stock options given to top 5 employees
- With lower tax brackets, it is less critical to hold stock for 2 years after date of ISO exercise
- With higher exemptions, employees are less likely to trigger AMT when exercising ISOs
- Higher estate & gift tax exemptions call for new tax planning strategies

When choosing between two evils,

I always like to try the one I've never tried before.

- Mae West

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