

The Tax Consequences of Choice: Options, Futures, Rights & Warrants

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Summary

What are they? Who has them? What do you do with them? How are they taxed? These and other questions will be answered in plain English, giving tax professionals a better understanding of the investment world. Topics will include puts, calls, rights, warrants, futures, forwards, foreign currency transactions, employee stock options, incentive stock options, as well as the trading methodologies and tax treatments of each—basis, income recognition under IRC §83(b), and (of course!) AMT.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

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I. Introduction

An option is a choice to do something—whether you state your preference, make a selection, come to a decision, or simply elect to “keep your options open”; you are presented with the opportunity to evaluate alternatives. Our discussion will begin with an explanation of options in the general sense and then focus on options specific to the investment world, including puts, calls, rights, warrants, futures, and foreign currency transactions.

II. The Language of Options

Using a real-world analogy familiar to readers, I will teach you options-speak; a language unto itself. To the uninitiated, the vocabulary at first sounds familiar since words are used which we use in our everyday communications. Unfortunately, confusion sets when it becomes obvious that these words have taken on new (and foreign) definitions. By focusing on terms – just as you would if you were attempting to learn French or Spanish – the world of options opens up.

Let’s start off with a grocery store coupon; the kind that you clip out of the Sunday paper. Maybe it’s a corn flakes coupon that allows you to buy cereal for a fixed price of \$3/box. This coupon gives you a choice to go shopping and buy cereal at a bargain price; or you may choose not to use your coupon if you want a different brand or don’t want cereal at all. Because you have a choice, you have an **option**.

A. The Players

Options always require two players: In this case, we have you (the coupon clipper / cereal shopper) and the issuer (the cereal manufacturing company that is offering the discount) – let’s call them Kellogg’s to keep things simple. As the coupon clipper, you are known as the **holder** since you quite obviously are in possession of the coupon and are holding it. Kellogg’s is known as the **writer** since it created the coupon and allowed it to be printed in the paper. Notice that you as the cereal shopper have choices but that Kellogg’s as the issuer has none. If you choose to go shopping and buy cereal, Kellogg’s *must* honor the coupon and sell the cereal to you at the discounted price.

RULE # 1: Options always involve two parties – one party (the holder) will always have a choice; the other (the writer) will always have an obligation.

B. The Rules

Coupons – and by extension options – have an **expiration date**. In the case of the cereal coupon, you must make your decision to buy cereal before the deadline, usually written in microscopic fine print. If, by chance, you do not make your decision in a timely manner, the coupon becomes useless. Your only choice is to toss it in the trash.

Options are not free. Even the corn flakes coupon cost \$1 since it could only be obtained by buying the Sunday paper; the price that you paid for the paper effectively is the price you paid for the coupon. We refer to that price as the **premium**. Premiums in the investment world are, for the most part, determined by supply and demand. Since there is only a limited supply of regulated stock options, the cost of these options will increase if many people wish to purchase them and the price will drop if few people want to buy them.



The premium is comprised of two components: Time value and the bargain element. If, for example, a coupon gives you the right to buy one box of cereal for a fixed price of \$3/box (**strike price**) but the current market price of cereal is only \$2, the option would be uninteresting since it would not offer a bargain. On the other hand, as soon as the market price of cereal climbs above the strike price, the coupon becomes attractive since it would allow you to make a bargain purchase. This option would have **intrinsic value** and would be attractive to you as well as others who might wish to buy it from you.

As the market price of cereal rises and falls over time, your coupon becomes more or less valuable. A simple comparison between the coupon's strike price which remains unchanged and the fluctuating market price of cereal affords you the ability to determine whether the coupon offers potential savings. You have the choice to cash in on the bargain by using the coupon to purchase cereal or selling the coupon to someone else who may wish to use it to purchase cereal. Indeed, if enough folks recognize the bargain element inherent in the coupon, they will clamor for it and start a bidding war. Thus, you see that while strike price and market price represent differing values, their link is reflected in the premium which will rise and fall as the comparison between strike and market prices becomes more or less favorable.

But time inevitably runs out at expiration. Prior to that deadline, you have the choice to buy cereal at a fixed price; once the deadline is reached, neither you nor anyone else can benefit from any potential bargain by using the coupon to buy cereal. The coupon has expired and is now worthless.

RULE # 2: An option's premium will rise and fall in relation to the market price of the underlying asset, but the premium will ultimately trend to zero as the option becomes worthless at expiration.

C. **The Game**

With a basic understanding of the rules, we can now begin play...

The Cereal Shopper's Play

Say you like to eat cereal and always want to be sure that you have a well-stocked supply; yet you worry about price-creep. Of course you could buy huge quantities of cereal next time it goes on sale but it's likely that you don't have a large enough pantry to store all the boxes and a large enough appetite to eat their contents before the cereal goes stale. Wouldn't it be nice if instead you could negotiate with Kellogg's and lock in a price that would guarantee you a good deal in the future?

Indeed, we have just such a mechanism: By purchasing a **call** option on cereal, you would have the right to buy corn flakes at, say, \$3/box (strike price) any time during the next year (expiration). Let's further assume that the market price of corn flakes is currently, and not so coincidentally, \$3/box. At first blush, you might wonder why you would spend money to buy an option that would allow you to buy cereal for \$3 when you could simply run to the market and buy the actual product for the same price. But then you remember that you don't need cereal right now but are still worried that the cost of cereal will rise just when you want to purchase it at some point in the future.



Holding the call eliminates that worry. Thus, the cost of the option, say \$1 (premium), buys you time.

Let's see what happens down the road as cereal prices in the grocery store remain unchanged, rise or fall...

1. If the price of cereal stays flat, you will have the choice to buy cereal on the open market at \$3/box or use your call to buy cereal at \$3/box – no great deal either way. But for only \$1, you were able to buy yourself an insurance policy. It turns out that you might not use the insurance but it's a safety net (just like car insurance) that would protect you against future price hikes, if needed.
2. If the price of cereal rises, you'll most definitely want to take advantage of the bargain that the option now presents and buy cereal at \$3/box rather than at the market price. As long as the market price of cereal rises above \$4, you'll recoup not only the strike price but also the premium that you paid to purchase the option. And if you didn't want to eat the cereal yourself, you could always sell the box to someone else for the current (ever-increasing) market price and reap a profit.
3. If the price of cereal drops below the strike price, you'll simply let your call expire since there would hardly be a point to using it. Of course, you would forfeit the premium you had paid for the option.

Market Price	Exercise? (= use Call to buy Cereal)	Money In or Out Premium = \$1 Strike Price = \$3	Potential Gain or Loss
Unchanged	Maybe	1 out	\$1 Loss
Up	Yes	4 out	Unlimited Gain
Down	No	1 out	\$1 Loss

The Cereal Seller's Play

Just as shoppers are worried about rising prices, Kellogg's would be worried about falling prices and would love to lock in a satisfactory sales price. Kellogg's can do just that by purchasing a **put** option that would give the manufacturer the option to sell cereal for \$3/box (strike price) any time during the next year (expiration); indeed, forcing a shopper to make the purchase!

Again, actual market prices may remain unchanged, rise or fall and Kellogg's may or may not realize benefits from the play:

1. If the price of cereal stays flat, Kellogg's will have the choice to sell cereal on the open market at \$3/box or use the put to force a shopper to buy cereal and pay \$3/box – either way, Kellogg's paid \$1 for the put and can collect no more than \$3 for each box of cereal sold.
2. If the price of cereal rises, Kellogg's will allow the option to expire since the company would much rather sell cereal on the open market at the current price rather than at the strike price.
3. If the price of cereal drops below the strike price, Kellogg's will eagerly force some hapless cereal buyer to spend \$3/box. Kellogg's will profit from the difference



between the strike price and the premium; merely a small profit but a profit nonetheless earned at a time when cereal prices are declining!

Market Price	Exercise? (= use Put to sell Cereal)	Total Spent Premium = \$1 Strike Price = \$3	Potential Gain or Loss
Unchanged	Maybe	1 out	\$1 Loss
Up	No	1 out	\$1 Loss
Down	Yes	1 out + \$3 in	\$2 Gain

RULE # 3: The holder of a call believes that market prices will increase [he's bullish] and uses the option to lock in a favorable purchase price; the holder of a put projects price declines [he's bearish] and uses his option to lock in a satisfactory sales price. For every bull, there's a bear!

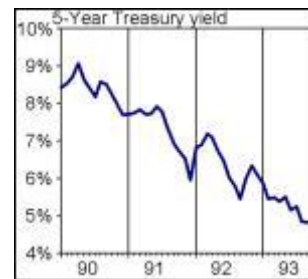
Terms Defined

Option	a derivative that offers someone a choice to buy (or sell) an underlying asset
Holder	the purchaser of the option who has the choice to buy (or sell) the asset
Writer	the seller of the option, and the contra-party, who is forced by the holder buy (or sell) the asset
Call	gives the holder the right to <i>buy</i> an asset; forcing the writer to <i>sell</i> the asset
Put	gives the holder the right to <i>sell</i> an asset; forcing the writer to <i>buy</i> the asset
Premium	the price of the option, determined by intrinsic and time values
Strike Price	the pre-determined price at which the underlying asset will be bought (sold)



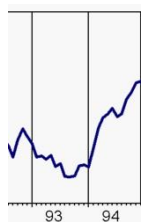
III. Applying the Lesson

Moving from the hypothetical to the actual, we can now see how the game of options is played in the investment world. To begin, I must stress that despite any protests to the contrary, investing in options is a gamble. Risk can be mitigated but never eliminated by careful research, market analysis, even formulaic stratagems but, in the end, investors simply cannot control the element of time which marches inexorably on.



Case in point: The Treasurer of Orange County, California was responsible for managing a \$7.5 billion portfolio of stocks and bonds. Worried that interest rates would continue to fall, Orange County invested in derivative securities in the hopes that these options would serve to protect the portfolio much in the same way that the cereal put served as an insurance policy for Kellogg's worried about market price declines.

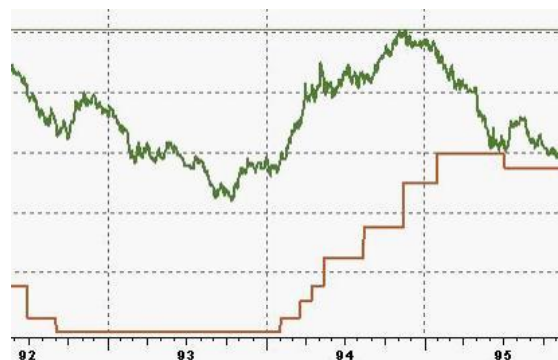
RULE # 4: Options as well as futures, rights and warrants are securities that are derived from underlying assets such as stocks, bonds, indices and commodities. Investments in derivative securities are indirect and do not represent equity positions; as such, their values are dependent on the performance of other assets.



Indeed, the long-term trend seemed to support the treasurer's fear and so he used borrowed funds to increase the size of the portfolio to \$20.5 billion, intending to pay back the loan when the derivatives paid off. Alas! In February 1994, The Federal Reserve instituted a series of six consecutive rate hikes. Time was up – Orange County's loans were called. The County was forced to sell its assets at bargain basement prices, realizing a \$1.6 billion loss by December 1994.

Was Orange County wrong? See for yourself...

By the middle of 1994, interest rates did indeed turn around and head in the "right" direction. Had Orange County held on, it would have reaped a profit rather than fall victim to bankruptcy. But the County did not have the luxury to wait and see – its options had expired. Time was up!



IV. Options Come in All Shapes

While analysis of a cereal coupon is a helpful tool, the analogy can take us only so far since grocery stores coupons are not in fact traded. Instead, we now turn to real-world derivative securities that may be bought and sold on the open market, and which provide investors with the choice to buy or sell underlying assets.

A. Regulated Stock Options

These options are standardized contracts created by the Options Clearing Corporation (OCC)¹ which not only establishes the trading ground rules but also approves which financial instruments may be selected by the exchanges to serve as underlying securities, including equities (stocks), indexes, debt securities (bonds) and foreign currencies. While the OCC employs various criteria, the primary factor influencing selection is the popularity of the underlying asset (evidenced by high trading volume), volatility and market capitalization. Much like gamblers in Vegas are offered odds on horse races and football games because there is sufficient interest, they are not offered the opportunity to bet on extreme ironing or buzkashi.² For example, while there are many thousands of stocks available for trade, only several hundred of these equities serve as underlying securities for options trading.

Regulated stock options were first introduced on the Chicago Board Options Exchange (CBOE) in 1973 – at that time, 16 stocks served as underlying securities and only 911 contracts were traded. Today, the CBOE reports that almost 5 billion contracts are traded annually on nearly 10,000 companies, stock indices, exchange-traded funds and even cyber-currencies which serve as underlying securities on four exchanges.³

As we have already learned, the holder of a call option hopes that the market will rise. If it does, he can **exercise** his option to buy the underlying stock at a previously fixed price which is presumably less than what he would have otherwise had to pay on the open market. Thus, this is a bullish strategy. On the other hand, the holder of a put hopes that the market will decline. If it does, he can exercise his option to sell the underlying stock at a previously fixed price which is presumably more than what he could otherwise have gotten on the open market. Thus, this is a bearish strategy.

	Seeks Protection (BUYS insurance)	Seeks Income (SELLS something)
↑ Bullish	BUY Call	SELL Put
↓ Bearish	BUY Put	SELL Call

The holder, however, need not exercise. He may instead allow his option to **expire**; thereby forfeiting the premium paid. Or, he may choose to **close out** (eliminate) his position, hoping to profit from the difference between the premium received on sale and the premium paid when he bought the contract.

¹ Founded in 1973, the OCC is “dedicated to promoting stability and financial integrity in the marketplaces.” The OCC acts as guarantor, ensuring that the obligations of the contracts it clears are fulfilled. [OCC’s mission statement, available at <https://prd.theocc.com/Company-Information/What-Is-OCC>, last accessed April 26, 2020].

² Extreme ironing is “the latest danger sport that combines the thrills of an extreme outdoor activity with the satisfaction of a well-pressed shirt.” Originating in England it is now a worldwide phenomenon that has taken place underwater, on mountainsides, and while parachuting. In contrast, the goal of Buzkashi is simple – grab the carcass of a headless goat at full gallop, get it clear of the other players, and pitch it across the goal line. Played all over South Central Asia, it is the national sport of Afghanistan. [*The 25 Most Obscure Sports in The World*, posted by David Pegg, available at <http://list25.com/the-25-most-obscure-sports-in-the-world/>, last accessed April 26, 2020].

³ Cboe history [available at <http://www.cboe.com/aboutcboe/history>, last accessed April 26, 2020].

Tax Consequences⁴

Options are capital assets and, therefore, all transactions involving the purchase, sale or expiration of options are deemed to be capital transactions reportable on Schedule D. Because regulated stock options have a maximum duration of 9 months – all expire on the third Friday of the expiration month – transactions relating to the disposition of these options are categorized as short-term since none can exceed the one-year holding period required for favorable long-term tax treatment. EXCEPTION: Long-term Equity Anticipation Securities (LEAPS), introduced in recent years, expire within three years; LEAPs, therefore, can generate long-term capital gains.

1. Tax Consequences for the Holder (buyer of the option)

To begin, the holder of an option – whether call or put – was required to pay for the option and spent the premium plus any commissions his broker may have charged him. This total, then, represents the holder's cost basis. If no further transactions transpire and the option becomes worthless at expiration, the holder will forfeit his entire investment and suffer a short-term capital loss equal to his cost basis [long-term in the event of a LEAP held for more than one year].

However, you may recall that the holder has several choices which he may employ at any time prior to the option's expiration date. If, for example, the holder elects to use (exercise) his call option to purchase the underlying security, the cost basis of the option is simply added to the cost of the security purchased at the strike price. The taxpayer's holding period for the stock begins on the day after the option is exercised.

On January 13, 20YY when the price of EFG stock is \$15.48/share, Bob buys a JUL 14 Call on EFG for \$2.52. Translated into English, Bob has just spent \$252 (plus commissions; let's assume \$50) on an option contract that allows him to buy 100 shares of EFG stock for \$14/share any time between now and the expiration date on July 20th, 20YY.⁵

This option is currently in-the-money; in other words, if Bob were to exercise the option, he would be able to purchase EFG stock for a savings of \$1.48/share (= Market Price – Strike Price). If Bob did in fact exercise his option, he would have no immediate taxable event but would instead add the cost of his option (\$252 premium + \$50 commission) to the cost of the newly purchased stock (\$1400 strike price) for a total cost of \$1702 (his basis). Should he later sell the stock, he would use this basis to determine his realized gain or loss.

Rather than exercise, the holder may decide to close or rid himself of the position by selling the option – not the underlying stock – to another investor at a price determined by prevailing market conditions. Now the taxpayer must recognize a capital gain or loss equal to the difference between his selling and purchase price of the option (net of commissions).

⁴ IRC §1234.

⁵ Standardized nomenclature ensures that all investors know to multiply premiums and strike prices by the standardized contract size of 100 shares and that July 20th, 20XX happens to be the 3rd Saturday of the stated expiration month. This means, that the option was originally created nine months before its expiration and was first traded in October 20XX.



On April 10th, 20YY, Bob sells his JUL 14 Call on EFG for \$0.96 when EFG stock is trading for \$13.50/share to another investor who remains optimistic that EFG may yet climb above \$14/share in the remaining months before expiration. Bob must now recognize a capital loss of \$256, computed as follows:

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

In summary, the holder of a call will be subject to the following tax treatments:

Action Taken	Tax Consequence
Expiration	STCL (= premium + commissions paid)
Exercise	No gain or loss until disposition of <i>stock</i> Basis of stock = strike price + option premium paid
Close Out	STCG if net premium received > net premium paid STCL if net premium received < net premium paid

As can be seen from the chart above, option transactions are not taxed until such time as the position is closed, exercised, or allowed to expire. If those transactions occur after the end of the taxpayer's taxable year, income recognition is deferred.

2. Tax Consequences for the Writer (seller of the option)

The premium a holder pays for an option – whether call or put – goes to the writer (less any commissions the writer may owe to his broker to carry out the transaction). Although it may seem logical to report the premium as taxable income, the writer does not actually have a taxable consequence since it is (as yet) unknown whether he will realize a gain or loss. Keep in mind, with the exception of closing out his position (ridding himself of the option by unloading it onto another investor), the writer remains at the mercy of the holder's decision to exercise or allow the option to expire. Until the holder makes that decision, the writer cannot know his tax consequences.

However, the expiration of an option is deemed to be a capital event, resulting in the recognition of a short-term capital gain equal to the premium the writer originally received. Similarly, if the option position is closed out, the writer must recognize a gain or loss based on the difference between the net premium originally received and the net premium later paid to eliminate the position.

To close or eliminate an option position, the investor must make a transaction that is opposite of the one that originally established his position. Thus, the holder of an option – who originally purchased the option and now wants to rid himself of it – must later sell that option to remove the investment from his portfolio. On the other hand, the writer of an option – who originally sold the position and took in cash – must now buy back the position and spend cash to remove the investment from his portfolio. REMEMBER: Holders *sell* and Writers *buy* to close out their option positions.



Finally, if the holder of a call option elects to exercise and forces the writer to deliver the underlying security, the writer will receive sales proceeds equal to the strike price of the stock he just delivered. The writer must now recognize a short- or long-term gain or loss, depending upon how long he held the underlying security and the cost basis of his shares (adjusted for the option premium he previously received).

On January 13, 20YY, Charlie sold the JUL 14 Call on EFG to Bob – the contra-party to the transaction – and received \$252 (less a \$50 broker's commission). Charlie does not yet have a reportable event.

*However, if Bob chooses to exercise the call, Charlie will be required to deliver 100 shares of EFG stock to Bob and will receive payment from Bob totaling \$1400. Assuming that Charlie originally purchased 100 shares of EFG on September 30, 20XX for \$13.17/share precisely in the event he would be called upon to **cover** his option position, Charlie would realize:*

Sales Price of Stock	\$1400
– Cost of Stock \$1317 + Comm \$50 – Option Inc \$202	<u>1165</u>
= Realized Gain	\$235

Of course, you might wonder why Charlie would go to such lengths to make a profit of only \$235. And indeed, it would appear to be pointless unless Charlie had previously managed to purchase the 100 shares of underlying stock for something less than \$13.50/share.

In fact, imagine that Charlie owned EFG all along – purchased for just about a dollar per share when the stock was first issued in 1996. In the interim, Charlie watched his investment increase to well over \$100/share, drop precipitously during the next two years and ride a mild roller coaster between \$12 and \$40/share ever since. Charlie is content to hold the stock since he believes in its long-term growth prospects but is disappointed that EFG has not paid out any dividends in all these years. Charlie's broker suggested that he could generate an income stream by writing covered calls, whereby he earns the premium on call options he sells to Bob and others. If the market price of EFG remains below the selected strike price, the calls will remain unexercised; Charlie will be able to keep his premium and his stock and can then repeat the process by writing another covered call. If the market price exceeds the strike price, Bob will almost assuredly exercise the option and Charlie will have to deliver (sell) his stock. But remember, he bought that stock long ago for next to nothing and now realizes a significant gain as well as the premium he collected when he wrote the option.

In some instances, writers may choose to remain **uncovered** – a far riskier endeavor since they will be called upon to deliver stock they do not yet own. Uncovered writers will be required to purchase shares at the prevailing market price if the call is exercised by the holder. Since the holder will only choose to exercise when the market price exceeds the strike price – and there's no telling just how high that market price might be at that time(!) – the writer faces unlimited exposure.

In summary, the writer of a call will be subject to the following tax treatments:



Action Taken	Tax Consequence
Expiration	STCG (= premium - commissions received)
Exercise	ST or LTCG if Strike Price > Basis of <i>stock</i> ST or LTCL if Strike Price < Basis of <i>stock</i> Basis of stock = Cost of stock - net premium received
Close Out	STCG if net premium received > net premium paid STCL if net premium received < net premium paid

We have, so far, discussed the tax consequences of call options but not put options. Where calls give the holder the choice to buy and the writer an obligation to sell the underlying security, puts do the opposite in that they give the holder the choice to sell and the writer the obligation to buy the underlying security. While it's easy to offer real-world examples of calls (corn flakes coupons and car warranties), it's difficult to come up with practical comparisons of puts since it almost seems counter-intuitive to force someone to buy something at the whim of the put holder. Nevertheless, it is so!

As a result, I often suggest that readers stick with the easier concept – that of a call – and simply accept that puts are the opposite of calls. Once you grasp the concept of calls, just flip that concept upside-down and now you “understand” puts. I offer a complete summary of tax consequences below and ask you to note that the tax consequences for holders at expiration or closing are the same, regardless of whether calls or puts are involved. It is only upon exercise, that the tax consequences differ.

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

* This chart presumes an investment in regulated stock options with maximum expirations of 9 months. An investment in LEAPs could, of course, yield long-term capital gains or losses.

3. Holding Periods

As discussed previously, holding periods for option positions, whether expired or closed, are determined by the amount of time the positions remained open. Since regulated stock options most frequently have a maximum duration of only nine months, both holders and writers generally realize short-term gains and losses with holding periods that begin when the positions are opened and end when the options become worthless at expiration or the positions are eliminated in closing transactions. If, however, the positions are exercised, holding periods are attached to the underlying securities rather than to the options themselves.⁶

⁶ IRC §1223.

To further complicate matters, writers of covered calls – investors who have sold a call option and hold the underlying stock – must establish if their options are in-the-money, at-the-money or out-of-the-money and only then can determine the holding period of the stock. A simple comparison between the strike price of the option and the market price of the stock is used to determine whether potential exercise of the option would be favorable for the holder. Thus, if the strike price is less than the market price, the holder could exercise his option to call the stock away from the writer and purchase the stock at a bargain, ultimately putting money *in* his pocket. Conversely, if the strike price is greater than the market price, the transaction would be unfavorable for the holder and he would have to shell *out* money from his pocket. And if the strike and market prices were equal, the holder would find neither benefit nor detriment to exercise; the option is said to be at-the-money.⁷

Stock holding periods are irrelevant for at-the-money and out-of-the-money calls since neither would be exercised. However, options with intrinsic value must next be separated into qualified⁸ and non-qualified categories to determine if the holding period of the underlying stock is suspended and restarted at the end of the option's life [qualified] or eliminated, reset to zero, and restarted once the option expires or is closed [non-qualified].

4. Wash Sale Rule⁹

This rule was established to prevent investors from making illusory sales for the purpose of converting paper losses into recognized losses on the tax return. The rule states that an investor, who sells a security at a loss, may not repurchase substantially the same security within 30 days before and 30 days after the date of the sale.

On June 30, 20XX, the investor bought 100 shares of ABC for \$4,000. On August 4, 20XX he sold the shares for \$3,300 and then purchased another 100 shares of ABC for \$3,900 the next day. Although the investor realized a loss on the sale of \$700, he may not deduct it since he repurchased the same security before the expiration of the window. Instead, he must add the non-deductible loss to the cost basis of the new shares ($\$4,600 = \$3,900 + \$700$).

The taxpayer had, of course, hoped to deduct the loss on his return which otherwise would have remained unrealized.¹⁰ By repurchasing the same security, he had hoped to retain his position and benefit from future appreciation of the stock. The government cannot prevent an investor from buying and selling, but this rule is designed to discourage sales if done only to

⁷ Determination of in- or out-of-the-money is *always* performed from the perspective of the holder since he is the transaction participant who must determine whether exercise would in fact be favorable or not.

⁸ Qualified in-the-money options are those which are exchange-traded, written on stock already owned by the call writer, have more than 30 days remaining until expiration, and have a strike price only minimally less than the security's market price. [Brasher, John, *Tax Rules on Stocks and Stock Options*, available at http://www.allstocks.com/stockmessageboard/ubb/ultimatebb.php/ubb/get_topic/f/11/t/000131/p/1.html, last accessed April 26,2020].

⁹ IRC §1091.

¹⁰ Wash Sale transactions are reported on Schedule D in the normal manner, but a second line entry will be required to remove the disallowed loss by entering it as a positive number as an offset to the loss claimed on the line above.



recognize losses rather than for viable investment reasons. Tax consequences should never be the sole or even the primary motivation for making investment decisions.

On the other hand, if the investor had waited until September 5, 20XX to repurchase the stock, his loss would have been deductible. It is assumed that if someone were to sell a security and then willingly wait for at least a month to repurchase it, he would be exposed to market fluctuations just like any other investor. If he is willing to take that risk, the wash sale rule will not prevent his actions.

Some taxpayers try to circumvent the rule by purchasing other securities. For example, the investor may hope to sell ABC common stock and replace it with ABC preferred stock. Sadly, this will not “fool” the tax authorities as the rule clearly stipulates *substantially the same* securities. Thus, the following transactions would all fail under the rule: (a) ABC common stock for ABC call option; (b) ABC preferred stock for ABC convertible bond; (c) ABC bearer bond for ABC registered bond.

Typically, if the securities are issued by the same corporation, they will likely be deemed as being substantially the same. Buying a deep in-the-money call on an underlying security sold within the previous 30 days would fall under the category of “substantially the same” since the holder could readily exercise his option at any time to replace his shares of stock, but the writer of this same call would not be subject to the wash sale rule since the sale of this option does not serve to reinstate his stock holding.

B. §1256 Contracts

Regulated futures, non-equity options and foreign currency contracts are known as §1256 contracts. Frequently, §1256 transactions remain open at year-end; in other words, the contract has not yet expired or been exercised. However, mark-to-market rules require that the investor treat these contracts as if they had been sold at their Fair Market Value (FMV) on the last day of the tax year. 60% of the computed gain is then treated as long-term while the remaining 40% is treated as short-term on **Form 6781**, Gains and Losses from Section 1256 Contracts and Straddles.

1. Futures

A futures contract, also known as a forward contract, is very much like a regulated stock option in that it gives the holder the right to purchase an item at a specified price at a specified time in the future. However, there are some significant differences:

- Futures, unlike options, involve commodities such as oil, metals, grains, and livestock. Financial futures are now available as well.
- Futures trade using the open outcry system on a commodities exchange.¹¹

¹¹ The wild system of open outcry in trading pits has almost entirely been replaced by electronic trading. Observers hoping to witness the wild and frenetic activity once an integral part of the trading floors, must content themselves with Hollywood’s depiction in *Trading Places* with Dan Ackroyd and Eddie Murphy [video excerpt is available at https://www.youtube.com/watch?v=-4_fwzC4PNI; last accessed April 26, 2020].



- But most importantly, futures must be exercised upon expiration and require the physical delivery of the underlying commodity as opposed to options which can expire unexercised. Thus, the holder of a pork belly contract must have a BIG freezer when 40,000 pounds of bacon are delivered to him on the expiration date!

Futures contracts were first created in Japan during the 1600's by landlords collecting rents from their tenants in the form of bushels of rice. Both landlords and tenants were concerned about price fluctuations throughout the growing season – tenants were concerned with price decreases, landlords with price increases. Futures contracts offered each party a hedge and allowed third parties to speculate, ultimately increasing overall market liquidity. Pricing – then and now – is based strictly on supply and demand. Today, the American futures markets are regulated by the Grain Futures Act (1922), the Commodities Exchange Act (1936), the Commodities Futures Trading Commissions Act (1974), the Commodity Futures Modernization Act (2000), and the Dodd–Frank Wall Street Reform and Consumer Protection Act (2010).

A more down-to-earth example of a futures contract with which we are all familiar would be a real estate sales contract whereby buyer and seller agree on a closing date (in the future), establish a price, identify a quantity (one house), and specify the quality of the commodity to be transferred (e.g. with a new roof).

An investment known as a securities futures contract, allows the investor to enter into a contract to buy or sell a single security or a narrow-based index in the future. As this is very similar to an equity option, it is treated in the same manner and is therefore not deemed to be a §1256 contract.

2. Foreign Currency Transactions

The IRS distinguishes between two types of currency transactions—those that are regulated and those that are not regulated, depending upon the market in which the currencies are traded.

Non-Regulated Transactions (subject to IRC §988)

These transactions, known as cash forex, include all trades which take place in the interbank market¹² as well currency futures traded on a regulated commodities exchange. Resulting gains and losses are treated as ordinary income and taxed at the taxpayer's marginal tax bracket; losses are not limited by the \$3,000 capital loss rule.¹³

NOTE: Because interbank markets are not regulated, taxpayers' transactions will not be reported to the IRS on **Forms 1099**. Nevertheless, these trades are taxable and should be reported on **Form 1040**, Other Income by investors and on **Form 4797** by traders.

¹² The interbank market is used by banks and financial institutions, excluding retail investors and smaller trading parties, to trade foreign currencies.

¹³ Wash Sale and Mark-to-Market Rules also do not apply to §988 transactions.

Under certain conditions,¹⁴ a taxpayer may elect out of §988 treatment, thereby converting his ordinary gains to §1256 capital gains, reportable on **Form 6781**. The election does not apply globally, but rather on a trade-by-trade basis and is best made when the transaction has resulted in a taxable gain (since loss treatment is more favorable under §988).

Regulated Transactions (subject to IRC §1256)

These transactions take place on a regulated exchange (not including currency futures) and are treated as capital rather than ordinary income. Regardless of the taxpayer's actual holding period, 60% of the resulting gains are treated as long-term capital gains ("LTCGs"); the remaining 40% are taxed as short-term capital gains ("STCGs"). These trades will be reported to the IRS on **Forms 1099** and must be reported by the taxpayer on **Form 6781**.

C. Rights and Warrants

Start-up companies often choose to raise capital by selling shares of stock to investors who then obtain the right to participate in the companies' anticipated profits as well as elect a Board of Directors that will guide the company in a manner acceptable to the investors. Shares may be offered privately or traded publicly on an exchange.

In some instances, companies may seek to raise capital by offering additional shares to old (and new) investors. Of course, these additional shares would dilute both the monetary as well as the beneficial value of the existing shares. Assume for simplicity's sake that XYZ Corporation originally offered 100 shares to investors and that you purchase 20 of these shares – you would own 20% of the company, have the right to receive 20% of the company's net distributable profits and have considerable voting power. If XYZ later chose to offer an additional 100 shares, your proportionate share of the company would decrease to only 10%. Surely you would be unhappy!

To appease existing shareholders, companies often offer stock rights to these existing shareholders, granting them the opportunity to purchase the newly issued shares directly from the company prior to the public offering. In effect, these rights are options that give shareholders the first right of refusal along with a choice to buy the shares at a discounted price before the remaining shares are sold to the public. Of course, existing shareholders have the choice to exercise and purchase new shares, close out their positions by selling the rights to third parties on a burgeoning secondary market, or simply allow the rights to expire; exactly the same choices that option-holders face.

Stock Rights

Typically, companies offer one right per share currently held by the existing shareholders and often require redemption of multiple rights to buy shares of the new offering within a reasonably short period of time; generally, 30 to 60 days. The rights are initially attached to the original share of stock but can be detached and traded separately during the offering period, ultimately expiring without value if not used to

¹⁴ IRC §988(a)(1)(B): This election can be made for transactions involving a forward or futures contract, or currency options which are capital assets in the hands of the taxpayer and are not part of a straddle (a position in which the investor holds both a call and put with the same strike price and expiration date).



purchase the new shares. The strike price of the right – the price at which new shares of stock can be purchased – is always set below the current market price of the stock, thereby ensuring that all rights have intrinsic value at the outset.

Warrants

Similar in many ways to rights, warrants may also be used to purchase additional shares of company stock. Yet, warrants differ from rights in the following ways:

- Warrants are usually attached to bonds rather than stock and are intended to induce investors to purchase a company's debt, knowing that they may later have the opportunity to obtain an equity position and benefit from the company's future growth prospects.
- Warrants have expiration dates that range from six months to a year or more.
- To discourage investors from immediate exercise, the strike prices of warrants are always set above the current market price of the underlying security.

But like rights, warrants may be detached from the bonds with which they were issued and can then trade in the open market. Thus, warrant holders will once again have the choice to exercise their warrants to obtain stock; or sell their warrants, reaping a profit on the sale of their options; or allow their warrants to expire.

Pricing

Allowing rights and warrants to expire is truly a silly – and often ignorant – choice made by holders who do not realize that they have essentially been given something of value for free. Both rights and warrants will, at a minimum, have time value and may well have intrinsic value if the strike price is less than the current market price of the underlying stock. It would be a poor choice to allow these options to expire rather than exercise or close out the positions profitably, but it happens frequently.

Once detached from the stocks or bonds with which they were issued, rights and warrants may be priced using the following formula:

$$\frac{(\text{Current Market Price of Stock} - \text{Strike Price of Option or Warrant})}{\text{Number of Rights or Warrants Needed to Obtain New Shares}}$$

Tax Treatment

Since rights and warrants are non-compensatory in nature – in other words, are not granted to company employees in exchange for services provided – the investor is not taxed at the time of receipt.¹⁵ Therefore, the basis of the rights or warrants issued to the investor is generally zero. However, investors may elect to apportion a part of the basis of the stock or bond to which the right or warrant was attached to the rights or warrants received.¹⁶

¹⁵ IRC §305(a).

¹⁶ As per Treas. Reg. §1.307-2, taxpayers must make an affirmative (and irrevocable) election by attaching a statement to the tax return for the year in which the rights or warrants were received.

Investor bought 200 shares of XYZ at \$2,000 and then received 20 rights allowing him to purchase an additional 20 shares at \$3/share. The FMV of the stock is \$1,900 on the date of distribution and the FMV of the rights is \$80. Basis is allocated as follows:

$$\begin{aligned} \text{Basis of Stock} &= \$1900 \div (\$1900 + \$80) \times \$2000 = \$1919 \\ \text{Basis of Rights} &= (\$80 \div \$1980) \times \$2000 = \$81 \end{aligned}$$

If the right or warrant is then detached and sold, the allocated basis should be used to determine the capital gain or loss on sale; the holding period – long or short – includes the holding period of the stock or bond to which the right or warrant had been attached.¹⁷

If, instead, the right or warrant is exercised and used to purchase additional company shares, no gain or loss would be recognized on the right or warrant. The basis of the newly acquired shares would include the purchase price of the new shares (strike price) plus the basis of the right or warrant. The holding period of the newly acquired stock begins on the day after exercise and does not include the pre-exercise period during which the right or warrant was held.¹⁸

Tax treatment at expiration will depend on whether the lapsing right or warrant was issued directly to the investor by the company or detached and acquired by the investor on the secondary market:

- The lapse of a purchased right or warrant will result in a capital loss to the extent of its acquisition cost; the holding period begins when the right or warrant is acquired.
- If the right or warrant was obtained by virtue of the fact that it was attached to an underlying asset, no tax consequence would ensue; instead, the basis which was previously – and temporarily – allocated to it would simply disappear and revert back to the basis of the stock or bond originally held.¹⁹

	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 <i>not</i> 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	Purchase Price of R or W	Begins on date of acquisition of R or W
	If received from Company at issuance, no gain (loss)	Allocated basis reverts to original Stock	N/A

¹⁷ IRC §1223(4).

¹⁸ IRC §1223(5).

¹⁹ *Stock Rights* [available at <http://costbasis.com/stkchanges/stockrights.html>, last accessed April 26, 2020]. NOTE: CostBasis.com offers a calculator to compute the allocated basis of stock rights.



D. Employee Stock Option Plans (ESOPs)

Often, a corporation gives its employees the right to buy shares of the employing company to motivate employees or provide for compensation that does not directly affect the bottom line of the employer in the current year. Although these options give holders (in this case, the company employees) the right to purchase shares of stock, they are not regulated nor standardized contracts and are treated differently than regulated stock options.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have sought to establish globally accepted standards mandating that companies treat stock options as an expense in the year granted based on fair-value (FV) accounting principles. This methodology requires the use of an accepted option pricing model (e.g. Black-Scholes) to establish the value of the option on the grant date. Once determined, the FV is deemed to be a deductible business expense which must be footnoted in the company's income statement. Neither Congress nor the IRS have yet weighed in with definitive regulatory guidelines.

1. Types of ESOPs

Statutory

These options are granted under a plan which meets certain requirements within the Internal Revenue Code (IRC). Again, two variants exist:

- Incentive Stock Options (ISOs) are often granted on a discriminatory basis to key employees and must be exercised within 10 years after the grant date.
- Employee Stock Purchase Plans (ESPPs) must be nondiscriminatory and are usually offered to non-management employees. They must be exercised within 5 years after the grant date if the price of the option is at least 85% of the FMV of the stock at the time of exercise. Otherwise, the option must be exercised within 27 months of the grant date.

Non-statutory

These options do not meet the criteria of the IRC.

2. Tax Treatment

ISOs (§421)

Recognition of Income: No income is recognized on the grant or exercise dates, only upon ultimate disposition of the stock. However, if the option is not exercised in the same year it was granted, the difference between the FMV of the stock and the Option Price will be considered a tax preference item for AMT purposes. This information will be provided on **Form W-2**, Box 14.

Treatment if Exercised: If the option is exercised and the stock is then held for at least one year past the exercise date and two years past the grant date, the eventual gain or loss will be considered long-term²⁰. Otherwise, there will be a Disqualifying Disposition and the resulting gain will be included as

²⁰ IRC §422.

compensation on **Form W-2**, Box 1. The basis of the stock is then increased by the amount of compensation recognized.

Holding requirement not met

On February 15, 20XX JKL granted an ISO option to buy 100 shares at \$10/share. Employee exercised the option on October 1, 20ZZ when the FMV of the stock was \$15/share. Employee then sold the stock almost immediately for \$16/share.

*The long-term holding period requirements were not met since the **stock** was not held long enough and so \$500 (= \$1,500 - \$1,000) was included on Form W-2, Box 1 in 20ZZ. Form 1099-B was issued showing sales proceeds of the stock as \$1,600. The adjusted basis was \$1,500 (= \$1,000 + \$500 compensation recognized) and so the resulting gain of \$100 was reported as a STCG.*

Holding requirement met & stock sold at gain

If the employee had instead met the long-term holding requirements, no compensation would have been recognized and the entire \$600 (= \$1,600 - \$1,000) would have been LTG.

Holding requirement met & stock sold at loss

Alternatively, if the stock had been sold at a loss, no compensation would have been recognized and the employee would have reported a LTCL.

CAVEAT: As mentioned repeatedly, investment decisions should not be based exclusively on tax considerations. Taxpayers should weigh whether the tax savings attributable to the difference between long-term and short-term capital gains rates justifies the market risk associated with the requirement to hold the stock for at least two years.

The reportable AMT amount may be added to the stock's AMT basis, which will eventually result in a smaller AMT gain than regular tax gain in the year of sale. In theory, the AMT paid in the year of exercise creates a Minimum Tax Credit (MTC) that can be used to reduce the regular tax liability when the stock is sold.²¹ But the taxpayer suffers significant tax consequences if the stock price should *fall* in the interim.

Taxpayer received ISOs to buy his employer's stock and exercised his options from 1998 – 2000, buying stock worth about \$4.5 million for only \$128,000. Of course, he paid over \$1 million of AMT in 2000 alone!²²

Then, in 2001, the taxpayer sold his stock for \$1.7 million, realizing a significant economic gain (= \$1.7 million – 128,000). Unfortunately, however, the stock sale generated a tax loss for AMT purposes (= \$1.7 million – 4.5 million).

The taxpayer attempted to subtract the difference between his regular and AMT basis from his AMT calculation in 2001 so that he would have an AMT net operating loss that he could then carry-back to reduce his prior AMT tax

²¹ IRC §53(b).

²² *Marcus*, 129 TC 4.



liabilities.²³ But the court held that there was no regulatory authority for this negative adjustment in the year of the stock's sale; instead, only the positive basis adjustment [mentioned above] was allowed. Therefore, instead of an AMT NOL carry-back, the taxpayer was faced with a very large AMT basis that then created a huge AMT loss. And that loss—because stock was a capital asset—was limited to the \$3,000/year limitation on capital losses!

Minimum Tax Credit (MTC)

While the MTC is generated on the AMT side, it is a credit that can be used against a taxpayer's regular tax liability. In 2007 through 2012, the MTC was partly refundable. For taxpayers with an AMT liability resulting from transactions that occurred before the MTC became refundable, a "Bail-out Bill" came to the rescue,²⁴ abating any underpayment of outstanding tax attributable to an AMT adjustment for ISOs in any tax year prior to 2008. For tax years beginning in 2013, the MTC is no longer refundable; any unused amount may instead be carried forward into future years.

ESPPs

Recognition of Income: No income is recognized on the grant or exercise dates, only upon ultimate disposition of the stock. No AMT adjustments are required.

Treatment if Exercised: If the option is exercised and the stock is then held for at least one year past the exercise date *and* two years past the grant date, any gain will be considered long-term.²⁵ Losses occurring when the stock disposition price is less than option price are reported as LTCL and no compensation will be recognized.

Holding requirement not met

On February 15, 20XX JKL granted an ESPP option to buy 100 shares at \$10/share when the FMV was \$12/share. Employee exercised the option on October 1, 20ZZ when the FMV of the stock was \$15/share. Employee then sold the stock almost immediately for \$16/share.

The long-term holding period requirements were not met and so the employee would report ordinary income of \$500 (= \$1,500 - \$1,000) and a STCG of \$100 (= \$1,600 - \$1,500).

Holding requirement met & stock sold at gain

If the holding periods had been met, the employee would report \$200 (= \$1,200 - \$1,000) as ordinary income and \$400 (= \$1,600 - \$1,200) as LTCL.

Holding requirement met & stock sold at loss

If the stock had instead been sold at \$7/share, the employee would report a \$300 (= \$1,000 - \$700) LTCL and no compensation would have been recognized.

²³ The taxpayer based his argument on IRC § 56(d)(1)(B) that says that the AMT NOL calculation starts with regular tax income, adjusted for AMT deductions and preference items.

²⁴ MTC became a refundable credit with the Tax Increase Prevention Act of 2007. The refundable provision was extended several times in the following years through the end of 2012.

²⁵ IRC §423.



Non-statutory Stock Options

Non-qualified Stock Options (NQSOs) are taxed as compensation on the grant date if the option has a readily determinable FMV and the option is transferable or not subject to forfeiture should the employee fail to comply with specific conditions imposed. The income recognized is the difference between the FMV of the option and the price paid for it, if any. This amount is reported on Form W-2, Box 1.

If the FMV cannot be determined on the grant date, recognition of income is postponed until the option is either exercised or transferred.

The basis of the stock acquired equals the amount paid for the option plus any amount the employee is required to include in income.

NOTE: For estate tax purposes, NQSOs may generate Income-in-Respect of Decedent (IRD) that must be included as part of the decedent's taxable estate on **Form 706**, as well income on the income tax return of the eventual recipient – **Form 1041** (if fiduciary) or **Form 1040** (if beneficiary). If the value of the option had been readily ascertainable at the time of grant, the employee would have been taxed on the value of the option in excess of any amount paid by him. As a result, no post-death recognition of IRD would have to accrue to the fiduciary or beneficiary. But because the option value at grant is often unknown, ordinary income recognition for most NQSOs must be postponed until exercise. If the employee did not exercise his option prior to death, IRD will be triggered. On the other hand, if prior to death, the deceased employee had elected ordinary income treatment at the time of option grant as per §83(b), no IRD would accrue to the fiduciary or beneficiary.

Employee was granted non-qualified options to purchase 500 shares of DEF Company at \$50/share. Employee died prior to exercise when the stock was valued at \$70/share. Employee's personal representative later exercised the options when the stock was trading at \$80/share.

The bargain element of \$30/share is in its entirety ordinary income; however, only the portion attributable to the increase in value during employee's lifetime is IRD. Thus, \$20 is IRD; the remaining \$10 is taxable income to the estate. Once the stock is later sold by the executor, the estate will be liable for capital gains equal to the excess of the FMV of the stock on the date of sale over the FMV of the stock on the date of exercise (i.e., the exercise price plus the amount included in ordinary income).

E. Restricted Stock²⁶

Company stock given to an employee at no cost may be subject to restrictions, such as forfeiture if the employee fails to meet certain requirements imposed upon him (e.g. a minimum term of employment or long-term performance-based goals). When this

²⁶ Rule 144 of The Securities Act of 1933. NOTE: The holding period limiting the resale of restricted securities has been shortened from 2 years to only 6 months, effective February 15, 2008.

restricted stock²⁷ is transferred to an employee as payment for services, the employee's income and the employer's deductions are not recognized until vesting occurs (i.e., until the stock is no longer restricted). The restricted stock – often referred to as Letter Stock or §1244 Stock – is recognized as compensation income to the employee in the year the forfeiture restriction lapses, or the stock becomes transferable. The amount included in income (subject to payroll tax withholdings) is the excess of the stock's value when the restriction lapses over the amount, if any, paid for the stock by the employee.

The §83(b) Election²⁸

In the alternative, an employee may elect to recognize the income on the date of the stock's receipt rather than on the date of its vesting. The employee must recognize compensation income (subject to payroll tax withholdings) on the date of transfer but receives no cash with which to pay the resulting tax. If the stock is subsequently forfeited, the employee cannot claim a deduction for the previously recognized income, although any amount paid for the stock may be deducted as a capital loss. There are no tax consequences when the stock vests. Appreciation between the transfer date and vesting date is not recognized until the stock is sold.

Any appreciation in the stock's value after the date of transfer is taxed as a capital gain when the stock is ultimately sold. The employee's holding period begins on the date of transfer. The employee is treated as the owner of the stock and, therefore, dividends on the stock are treated as ordinary but not compensation income, unless eligible to be treated as qualified dividends taxable at reduced capital gain rates.

The election is best made when:

- shares given to the employee have nominal value on the date of transfer,
- the employee pays full or substantial value for the stock, or
- significant appreciation between the date of receipt and the time that the stock vests is anticipated.

On the other hand, it is best to *not* make the election when:

- the employee would be required to recognize substantial income upon receipt of the stock, or
- the employee will likely fail to satisfy the conditions creating the substantial risk of forfeiture.

Without the §83(b) election

Employee (in top marginal tax bracket of 37%) was granted 1,000 shares valued at \$10/share. Employee will recognize no compensation income at the time of the grant BUT must recognize income when shares are vested. If FMV of shares at vesting 3 years later is \$40/share, employee must recognize \$40K ordinary income and will incur \$14,800 tax liability.

²⁷ Stock is considered substantially not vested (restricted) where the recipient risks forfeiture conditioned (directly or indirectly) upon the future (non)performance of substantial employment services AND where the stock is not transferable (i.e. the transferee is subject to the same forfeiture conditions as the employee). IRC §83(c).

²⁸ As per REG-135524-14, the written statement regarding an employee's choice to make the §83(b) election – previously mandated under Rev Proc 2012-29 – is no longer required for restricted stock transferred on or after January 1, 2015.



The cost basis of his vested shares would be \$40K. If the employee sells his shares immediately at vesting, he would realize no capital gains. His total tax outlay would be \$14,800, leaving him with net cash of \$25,200.

With the §83(b) election

Pursuant to the same facts, employee would recognize \$10K ordinary income at grant and owe \$3,700 tax. The basis of his shares would be \$10K.

Upon sale of the stock at \$40/share, employee would realize a \$30K LT capital gain (taxed at 20%) and incur a \$6K tax liability. His aggregate tax outlay would be \$9,700, leaving him with net cash of \$30,300 [\$5,100 more than if he had not made the election!].

Of course, if the stock had declined during the 3-year vesting period, the employee would have paid tax on the grant date, obtained a basis in his shares of \$10K, and would realize a capital loss (subject to the usual \$3K/year allowable deduction).

Restricted Stock Units (RSUs)

In many ways, RSUs are similar to restricted stock in that they represent an unsecured promise by the employer to grant shares of stock to the employee once vested. But RSU holders typically face fewer restrictions than do their restricted stock counterparts. Because shares have not yet been issued to RSU holders, they do not receive voting rights. Nor may RSU holders make a §83(b) election.

RSU holders have no reporting requirements at the time of award but must include the FMV of the stock as ordinary income when the shares are received. This amount is added to wage income on **Form W-2**, Box 1. If dividend equivalents²⁹ have been earned on the shares received, these will also be included in Box 1.

If the awarded shares are later sold, the transaction will be reported on **Form 1099-B**. Unfortunately, however, the basis of these shares will often be misstated on the brokerage firm's 1099. The taxpayer will have to refer to earlier paystubs to establish the amount of income inclusion at the time his shares were awarded.

²⁹ Actual dividends cannot be paid since RSU holders do not own shares, but some employers place additional funds into an escrow account to help the employee offset withholding taxes.



F. Summary of Tax Treatment

While the facts of the situation below merely repeat the examples given in the text above, I am providing a side-by-side comparison so that you may readily identify the tax treatments distinct to each type of employee stock option. Additionally, I have assigned letters to each part of the transaction so that you have a standardized algorithm that can be applied to any taxpayer's situation.

Facts of the Situation:

2/15/XX: Option granted to buy 100 shares of JKL at \$10/share (G) when FMV of stock = \$12/share (F)

10/1/ZZ: Option exercised when FMV of stock = \$15/share (E)

Stock is then sold at either \$16/share (Sg) for a gain
...or \$7/share for a loss (SI).

ISO LT hold met	ISO LT hold not met
No compensation Sg - G = \$600 LTCG (Net = \$600)	E - G = \$500 Ordinary Sg - E = \$100 STCG (Net = \$600)

ESPP LT hold met; sold at gain	ESPP LT hold not met; sold at gain	ESPP LT hold met; sold at loss	ESPP LT hold not met; sold at loss
F - G = \$200 Ordinary Sg - F = \$400 LTCG (Net = \$600)	E - G = \$500 Ordinary Sg - F = \$100 LTCG (Net = \$600)	No compensation SI - G = \$300 LTCL (Net = \$300)	E - G = \$500 Ordinary SI - E = \$800 STCL (Net = \$300)

Non-statutory Options
F - G = \$500 Ordinary Sg - E = \$100 LTCG (Net = \$600)

V. Impact of Recent Code Changes

While the enactment of the Tax Cut and Jobs Act (TCJA)³⁰ did not specifically change how stock compensation is taxed, numerous provisions nevertheless may have an indirect effect on investment strategies and tax planning, including:

Qualified Stock Grant for Private Companies

TCJA allows employees of certain privately held companies the option to defer income recognition at NQSO exercise or RSU vesting for up to five years.³¹ **NOTE:** The corresponding employer's tax deduction is also delayed if the employee elects to defer income recognition.

Repeal of Deductible Compensation Limit

Publicly traded companies may no longer deduct performance-based compensation in excess of \$1 million for "covered employees", including the CEO, CFO and top three highest-paid employees. TCJA established that a covered employee for purposes of the deduction limitation will forever be deemed to be a covered employee, in all future years of employment, as well as retirement.³² Additionally, TCJA eliminated the exclusion for commission-based pay and "qualified performance-based compensation," including restricted stock and stock options.³³

Reduction of Ordinary Income Tax Rates

The reduced differential between applicable ordinary tax and capital gains rates may encourage some investors to forgo the requisite two-year holding period between exercising their options and selling the stock.

Increased AMT Exemptions

Employees are less likely to trigger AMT when exercising ISOs and holding the stock. However, thanks to the Schedule A limitation on state and local taxes (SALT), AMT tax savings on ISOs may be less than overwhelming.

Increased Estate and Gift Tax Exemptions

With the doubling of the lifetime exemption from roughly \$5 million to more than \$11 million (indexed for inflation through 2025), employees who have become wealthy from company stock and options, may wish to adopt new wealth planning strategies.

³⁰ TCJA was enacted in late 2017 and became effective January 1, 2018. Unless individually renewed, most provisions of the act will sunset at the end of 2025.

³¹ IRC §83(i): The election to defer income on these qualified equity grants received after December 31, 2017 must be made within 30 days of vesting. Additional guidance is available in IRS Notice 2018-97.

³² IRC §162(m).

³³ IRS Notice 2018-68.