Non-Qualified Stock Options

One strategy companies use to reward employees is to give them options to purchase a certain amount of the company's stock for a fixed price after a defined period of time. The hope is that by the time the employee's options ***vest***—that is, at the time the employee can actually exercise the options to buy stock at the set price—that the market price of the stock has gone up, so the employee gets the stock for less than what it's selling for in the current market.

Unless you're an executive, the options you receive from your employer are probably ***non-qualified*** stock options. Non-qualified stock options are stock options that do not meet specific requirements in the Internal Revenue Code for special tax treatment. In other words, they just don't qualify for the treatment that executives get when they receive incentive stock options. In this article, you'll learn the tax implications of exercising non-qualified stock options.

Let's assume that you receive options for stock that is actively traded on an established market such as NASDAQ, but that the options themselves aren't traded. The tax catch with this type of option is that when you exercise the stock options to purchase the stock, you have taxable income to the tune of the difference between the stock price set by the option and the market price of the stock. In tax lingo, you must recognize taxable income equal to what's called the ***compensation element***.

Compensation Element

The compensation element is basically the amount of ***discount*** you get when you buy the stock using your option to buy it at a certain price, known as the stock grant price. You calculate the compensation element by subtracting the stock grant price from the market value:

(market value − stock grant price) × number of shares you buy = compensation element

The ***market value*** of the stock is the stock price on the date you exercise the options (the date you buy the stock under your option agreement). You may want to use the average of the high and low prices the stock trades for on that day.

The ***stock grant price*** is the amount that you can buy the stock for per your option agreement.

And here's the kicker: Your company must report the compensation element as an addition to your wages on your Form W-2 for the year you exercise the options. This means the IRS knows all about your windfall, and treats it as ordinary income.

When Do I Have to Pay Taxes on My Options?

First things first: You don't have to pay any tax when you're ***granted*** those options. If your boss just walked in and gave you an option agreement that allows you to purchase 1,000 shares of company stock, you have been ***granted*** the option to purchase stock. This grant by itself isn't a taxable transaction. It's only when you actually ***exercise*** those options or sell stock that you purchased originally with stock options that you have a taxable transaction.

How you report your stock option transactions depends on the type of transaction. Usually, taxable non-qualified stock option transactions fall into four possible categories:

1. You exercise your option to purchase the shares and you hold onto the shares.
2. You exercise your option to purchase the shares, and then you sell the shares the same day.
3. You exercise the option to purchase the shares, then you sell them within a year or less after the day you purchased them.
4. You exercise the option to purchase the shares, then you sell them more than a year after the day you purchased them.

Each category has its own tax issues.

1. You exercise your option to purchase the shares and you hold onto the shares.

In this situation, you exercise your option to purchase the shares but you do not sell the shares.

Exercise date:	6/30/2007
Exercise price:	$25
Market price on 6/30/2004:	$45
Number of shares:	100

Your compensation element is the difference between the exercise price ($25) and the market price ($45) on the day you exercised the option and purchased the stock, times the number of shares you purchased.

$45 – $25 = $20

$20 × 100 shares = $2,000

Your employer includes the compensation element amount ($2,000) in Box 1 (wages) of your Form W-2. Why is it reported on your W-2? Because it's considered "compensation" to you, just like your salary. So even though you haven't seen the profit, you're taxed on the compensation element just as if your boss had given you a cash bonus.

What if for some reason the compensation element is not included in Box 1 of your W-2? It's still considered part of your wages, so you must add it to Form 1040, Line 7 when you fill out your tax return.

2. You exercise your option to purchase the shares, and then you sell the shares the same day.

Exercise date:	6/30/2007
Exercise price:	$25
Market price on 6/30/2007:	$45
Sales price on 6/30/2007:	$45
Commission paid at sale:	$10
Number of shares:	100

As in the previous example, the compensation element is $2,000, and your employer will include $2,000 in income on your Form W-2. Remember: If for some reason the compensation element is not included in Box 1 of your W-2, it is still considered part of your wages, so you must add it to Form 1040, Line 7 when you fill out your tax return.

Next, you have to report the actual sale of the stock on Schedule D, Capital Gains and Losses, Part I.
Because you sold the stock right after you bought it, the sale counts as short-term (that is, you owned the stock for a year or less—less than an hour in this case). In this example, the date acquired is 6/30/2007 the date sold is 6/30/2007.

Then you have to decide whether you have gained or lost. The cost basis is $4,500, and the sales price is $4,490. The net loss is the difference of $10 (the commission), which is your short-term capital loss. Let's talk about how we determined these amounts.

a. The ***cost basis*** is your original cost (the value of the stock, consisting of what you paid, plus the compensation element). The cost basis, then, is the actual price paid per share times the number of shares ($25 × 100 = $2,500) plus any amounts you were already taxed on, meaning the $2,000 of compensation calculated above and reported on your Form W-2. Therefore, the total cost of your stock is $4,500.
b. The ***sales price*** is the market price at the date of sale ($45) times the number of shares sold (100); this equals $4,500. Then, you subtract any commissions paid for the sale ($10, in this example) to arrive at $4,490 as your final sales price. Because you sold stock, you'll probably receive a Form 1099-B, Gross Proceeds, from the broker that handled your option purchase and sale. That form should show $4,490 as your gross proceeds from the sale.
c. Subtracting your sales price from your cost basis, you get a net loss of $10.

Remember that that's a "tax loss." You actually came out well ahead since you sold for $4,500 stock that you purchased for $2,500 plus the tax bill on an extra $2,000.

3. You exercise the option to purchase the shares, then you sell them within a year or less after the day you purchased them.

Exercise date:	6/30/2007
Exercise price:	$25
Market price on 6/30/2007:	$45
Sales date:	12/15/2007
Sales price:	$50
Commission paid at sale:	$10
Number of shares:	100

Again, the compensation element of $2,000 (calculated as in the previous examples) is considered income and will normally be included in Box 1 of your Form W-2. Remember: If for some reason the compensation element is not included in Box 1 of your W-2, it is still considered part of your wages, so you must add it to Form 1040, Line 7 when you fill out your tax return.

Because you sold the stock, you must report the sale on Schedule D, as a short-term capital gain.

The stock sale is considered short-term because you actually owned the stock less than a year. In this example, the date acquired is 6/30/2007, the date sold is 12/15/2007, the sales price is $4,990, and the cost basis is $4,500. The net gain is the difference of $490. How did we get these figures?

- The ***sales price*** ($4,990) is the market price at the date of sale ($50) times the number of shares sold (100), or $5,000, less any commissions you paid when you sold it ($10). Form 1099-B from the broker handling your sale should report $4,990 as the gross proceeds from your sale.
- The ***cost basis*** is the actual price you paid per share times the number of shares ($25 × 100 = $2,500) plus the compensation element of $2,000 already included in your W-2 for a total of $4,500. So the gain is $490, the difference between your basis and the sales price, and will be taxed as a short-term capital gain at your ordinary income tax rate.

4. You exercise the option to purchase the shares, then you sell them more than a year after the day you purchased them.

Exercise date:	06/30/2006
Exercise price:	$25
Market price on 6/30/2006	$45
Sales date:	12/15/2007
Sales price:	$50
Commission paid at sale:	$10
Number of shares:	100

The compensation element is the same as in the preceding examples and should appear in Box 1 of your W-2 for the year in which you originally exercised the options to purchase the stock. Because this transaction occurred in a previous year, you don’t have to pay tax on the compensation element again; it’s now considered part of your purchase price for the stock.

This time, you must report the sale of the stock on Schedule D, Part II because it’s long-term; you owned the stock for almost 18 months. As in the preceding example, the amount of gain is $490, calculated in the same manner. But now it is a long-term gain, so you only have to pay at the capital-gains rate, which will probably be a lot lower than your regular income-tax rate.

Tips

When you are granted stock options, get a copy of the Option Plan or Prospectus from your employer and read it carefully.

Your employer is required to withhold payroll taxes from the compensation element, but occasionally that doesn't happen correctly. In one case we know of, an employee's payroll department did not withhold federal or state income taxes from the employee's compensation element. He exercised his options by paying $7,000 and sold the stock on the same day, making $70,000 on the deal, then took his proceeds (plus his savings) and bought an $80,000 car, leaving very little cash on hand. Come tax time, he was extremely distressed to learn that he owed taxes on the compensation element of $63,000 and he had no ready cash to pay his taxes. Don't let this happen to you.

Employers must report the income from a 2007 exercise of non-qualified stock options in Box 12 of the 2007 Form W-2 using a code of "V." The compensation element is currently already included in Boxes 1, 3 (if applicable), and 5, but now can be also be reported separately in Box 12 to clearly indicate the amount of compensation arising from an exercise.

See IRS Publication 550, Investment Income and Expenses (Including Capital Gains and Losses) and the Stock Options section in IRS Publication 525, Taxable and Nontaxable Income.