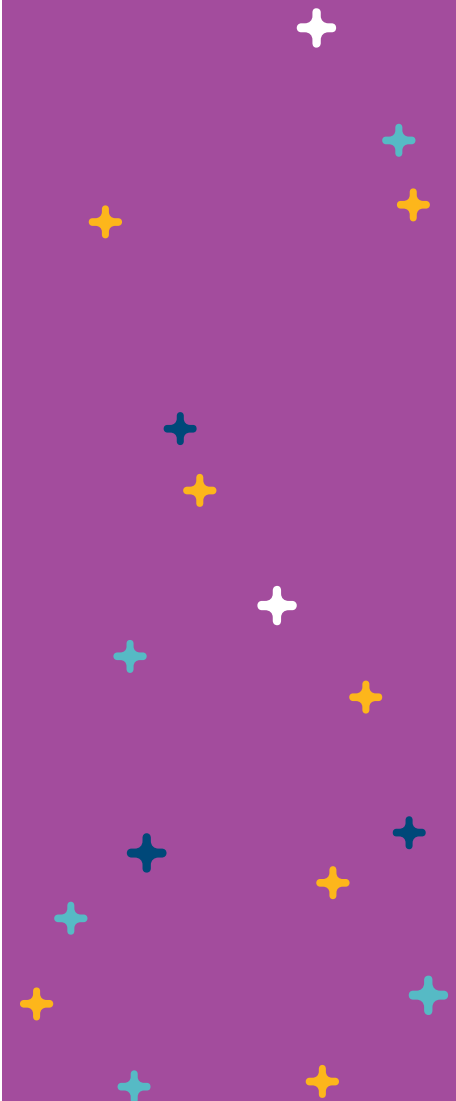


Tax Compliance and Planning for Individuals

Module

1	Compliance and Tax Planning Considerations	3
2	Loss Limitations	27
3	Compliance and Planning for Gift Tax and Charitable Donations	33
4	Personal Financial Planning	43



NOTES

1 Equity Compensation Awards

Employees may receive compensation from their employers in the form of equity awards such as stock options, restricted stock, or stock appreciation rights (SARs). How and when employee equity compensation is taxed to the employee depends on the type of equity award.

Key dates for equity compensation awards include:

- **Grant date:** when the employee receives the award
- **Vesting date:** when the employee has the right to exercise the equity award (restrictions lapse)
- **Exercise date:** when the employee purchases stock using stock options or cashes out SARs
- **Sale date:** when the employee sells restricted stock or stock acquired using stock options
- **Expiration date:** when the rights under the equity award lapse, or expire, unused

1.1 Nonstatutory Stock Options

Corporations may grant their employees the option to purchase stock in the corporation. There are two types of employee stock options: nonstatutory and statutory. A nonstatutory option (also known as a nonqualified option) is taxed when granted if the option has a readily determinable value at the time of the grant. Because nonstatutory options often do not have a determinable value at the time of grant, the option is generally taxed when exercised.

1.1.1 Definition of Readily Determinable Value

If the option is traded on an established market, it will have a readily determinable value. Otherwise, it will only have a readily determinable value if *all* of the following conditions are met:

- The option is transferable.
- The option is exercisable immediately in full when it is granted.
- There are no conditions or restrictions that would have a significant effect on the value.
- The fair value of the option privilege can be readily determined.

1.1.2 Employee Taxation: Readily Determinable Value

- If there is a readily determinable value, the employee recognizes ordinary compensation income in that amount in the year granted. If there is a cost to the employee, then the ordinary income is the value of the option minus the cost.
- There is no taxation on the date of exercise.
- The basis of the stock is the exercise price plus any amount previously taxed on the date of grant. Any future sale of the stock could result in a capital gain or loss.
- The holding period begins with the exercise date.
- If the employee allows the options to lapse (not exercised), there is a capital loss based on the value of the options previously taxed.

1.1.3 Employee Taxation: No Readily Determinable Value

- If no readily determinable value exists, the taxable event is the exercise date, not the grant date.
- On the date of exercise, the employee recognizes ordinary compensation income equal to the "bargain element"—the difference between the fair market value of the stock and the stock option price exercised.
- The basis of the stock is the fair market value of the stock when stock option was exercised. Any future sale of the stock could result in a capital gain or loss.
- The holding period begins with the exercise date.
- If the options lapse, the employee can deduct a capital loss equal to the price, if any, that the employee paid for the options. There are no other income tax consequences.

Example 1 Nonstatutory Stock Option

Facts: On July 1, Year 10, Bob was granted a nonstatutory stock option to purchase 200 shares of his employer's stock for \$12 per share. This option was selling for \$4 per share on an established exchange. Bob exercised these options on August 7, Year 11. The stock was selling for \$18 per share on the exercise date. On November 1, Year 12, Bob sold all of the shares for \$20 per share.

Required: Determine the amount and type of income that Bob must recognize and when the income should be recognized.

Solution: Bob must report ordinary compensation income in the amount of \$800 ($\4×200 shares) on the date of the grant in Year 10 because the option has a readily determinable market value.

Bob's adjusted basis in the stock is \$3,200 ($\$2,400$ exercise price + $\$800$ recognized ordinary income). The $\$2,400$ exercise price is 200 shares \times $\$12$.

Bob has a long-term capital gain in Year 12 in the amount of \$800, which is the selling price of $\$4,000$ (200 shares \times $\$20$) less the adjusted basis of $\$3,200$. The holding period begins from the exercise date, which is more than one year, therefore the gain is long-term.

1.2 Statutory Stock Options

There are two types of statutory stock options, incentive stock options (ISO) and stock options granted under employee stock purchase plans (ESPP). Both types of options are eligible to receive favorable tax treatment under the internal revenue code.

1.2.1 Incentive Stock Options

An ISO is a right that's given to an employee to buy stock in the company at a discount.

The following are some key points related to an ISO:

1. The ISO must be granted under a written plan document, approved by the shareholders, that indicates the total number of shares that may be issued and the employees that are eligible to participate.
2. The employee may not own more than 10 percent of the combined voting power of the corporation, parent, or subsidiary as of the date of the grant.

3. The employee must remain an employee of the corporation from the date the option is granted until three months (one year if due to permanent and total disability) before the option is exercised.
4. The options must be exercisable within 10 years of the grant date.
5. The exercise price may not be less than the FMV of the stock at the date of the grant.
6. Once exercised, the stock must be held at least two years after the grant date *and* at least one year after the exercise date.
7. An employee may exercise up to \$100,000 of ISOs in a year. Any amount exercised that exceeds this amount will be treated as a nonstatutory option.

1.2.2 Employee Stock Purchase Plans

An ESPP is a type of plan that allows employees to purchase company stock at a discounted price. With an ESPP, participating employees contribute to the plan through payroll deductions.

The following are some key points related to an ESPP:

- The plan must be written and approved by the shareholders.
- An ESPP cannot grant options to any employee who has 5 percent or more combined voting power of the corporation, parent, or subsidiary.
- Generally, the plan must be available to all full-time employees other than highly compensated employees and those with less than two years of employment.
- The option exercise price may not be less than the *lesser* of 85 percent of the FMV of the stock when granted or exercised.
- The option cannot be exercised more than 27 months after the grant date.
- No employee can acquire the right to purchase more than \$25,000 of stock per year.
- Once exercised, the stock must be held at least two years after the grant date *and* at least one year after the exercise date.
- The employee must remain an employee of the corporation from the date the option is granted until three months before the option is exercised.



Pass Key

Two/One: Stock acquired by exercising statutory stock options must be held at least *two* years after the grant date and at least *one* year after the exercise date to receive long-term capital gain treatment.

1.2.3 Taxation of Statutory Stock Options

- Generally, there is no taxation of the option as compensation.
- The basis of the stock acquired is the exercise price plus any amount paid for the option (if any).
- Gain or loss on a subsequent sale of the stock is capital if the stock is held for at least two years after the grant date and at least one year after the exercise date.
- If the two-year/one-year holding period requirements are not satisfied, any gain is ordinary up to the amount that the stock's FMV on the exercise date exceeds the option price. Any excess gain is capital gain. Any loss is a capital loss.