**Stock Options (Svoboda-TCM-20016-235)**

**Non-qualified Stock Options**

**Generally**, the income **tax treatment of
the grant of an option to purchase stock**
in connection with the performance of services, and the **transfer of stock
pursuant to the exercise of such an
option**, is determined under section 83(a) and the regulations thereunder.

Such stock options are known as “nonqualified stock options” or “nonstatutory stock options".

The receipt of a nonqualified stock
option does not generate income in
the recipient unless the option has a
readily ascertainable fair market value.

Instead, the recipient's exercise of the nonqualified option to acquire stock gives rise to gross income at the time of exercise. The amount of income recognized by the employee is equal to the amount by which the **fair market value of the stock** at the exercise date **exceeds the option price that he or she pays.** Sec. 83(a); *Racine v. Commissioner* [Dec. 56,583(M)], T.C. Memo. 2006-162; sec. 1.83-7(a), Income Tax Regs.

[Instructor note: this assumes there is no contingency that could cause the employee to have to sell the stock back to the company at cost – such as the requirement that the employee remain an employee for some time after exercise of the option.]

The recipient thereupon obtains a **basis** in the acquired stock equal to the **option price plus any amount includible in gross income as a result of the option exercise.** **Any gain or loss upon the subsequent sale of the stock will be capital in character.** Secs. 1001, 1221(a); sec. 1.83-4(b)(1), Income Tax Regs.

**Incentive Options**

Certain employee stock options qualify for alternative treatment under the provisions of section 421.

Specifically, section 421 applies to options that qualify as **incentive stock options** (ISOs) under section 422 (and to options that are issued pursuant to an employee stock purchase plan as defined in section 423).

When the applicable section 422 requirements for an ISO are met,
**section 421 provides that no income shall result at the time of the transfer of stock upon the exercise of the option.** **Sec. 421(a)(1).**

The stock acquired through the ISO exercise will generally qualify as a capital asset in the hands of the employee. **The difference** **between the amount received on disposition of the stock and the employee's basis** will be capital in character. Secs. 1001(a), 1221 and 1222; *Spitz v. Commissioner* [Dec. 56,589(M)], T.C. Memo. 2006-168; sec. 14a.422A-1, Q&A-1, Temporary Income Tax Regs., 46 Fed. Reg. 61840 (Dec. 21, 1981).

**However,** if the stock acquired pursuant to an ISO is disposed of by the option holder within 2 years of the granting of the option or within 1 year after the stock's transfer to him, section 421 does not apply, and the stock's acquisition and sale are taxed under the provisions of section 83. Sec. 422(a)(1); *Spitz v. Commissioner, supra;* sec. 14a.422A-1, Q&A-2(a), Temporary Income Tax Regs., 46 Fed. Reg. 61840 (Dec. 21, 1981).

There is limit ($100,000) on the amount of Incentive Options that may be exercisable. Limit on term is 10 years. Not an ISO if conditions are not met.

Need to add Sec. 83(b) and AMT