TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

HOW SHOULD TAX REFORM TREAT EMPLOYEE STOCK AND OPTIONS?

Donald B. Marron

October 4, 2017

ABSTRACT

This brief documents how the US tax system treats the most common forms of equity compensation, including stock, restricted stock units, and stock options. In most cases, these forms of equity compensation are taxed just like cash wages, salaries, and bonuses. Employees pay ordinary income taxes on the value they get from stock and most options. Employers deduct that value from their taxable income. And both employees and employers pay payroll taxes. The tax system thus creates a level playing field between equity and cash compensation. The large deductions businesses sometimes get for equity compensation—most famously when Facebook went public—are not a concern since they are accompanied by large tax payments by employees. Policymakers should maintain this equal treatment in any tax reform.

Donald B. Marron is the director of economic policy initiatives and an Institute fellow at the Urban Institute. Thanks to Lydia Austin, Mark Mazur, Steven Rosenthal, Eric Toder, and Jason Wiens for helpful comments, Elizabeth Forney and David Hinson for editing, and Yifan Zhang for preparing this brief for publication. This brief was funded by a generous grant from the Ewing Marion Kauffman Foundation. We are grateful to them and to all our funders, who make it possible for us to advance our mission.

The views expressed are those of the authors and should not be attributed to the Urban-Brookings Tax Policy Center, the Urban Institute, the Brookings Institution, their trustees, or their funders. Funders do not determine research findings or the insights and recommendations of our experts. For more information on Urban's funding principles, go to urban.org/support; for more information on Brookings' donor guidelines, go to brookings.edu/support-brookings/donorguidelines.

Commentators debate whether the United States taxes employee stock and options too little or too much. Some believe high-flying businesses get excessive tax write-offs when employees receive valuable stock or exercise options. Others believe the tax code places excessive burdens on some employees.

This brief takes a fresh look at these concerns and finds that America's basic approach to taxing employee stock and options is sound and should continue in any reform.

The current system taxes compensation from employee stock and most options just like cash wages, salaries, and bonuses. Employees pay ordinary income taxes on the value they get from receiving employer stock or exercising most options. Employers deduct that value from their taxable income. And both employees and employers pay payroll taxes on that value.

This approach makes sense. Policymakers should continue equal treatment in any reform. There is no reason for the tax code to either favor or disfavor stock and option compensation over cash compensation.

Some observers have expressed concern about the large write-offs successful businesses get when employees realize large gains from receiving stock or exercising options. Those write-offs can be larger than the amounts companies previously reported as compensation expense in their financial statements. Those differences have inspired proposals to limit the amount businesses can deduct from their taxes.

Policymakers should reject these proposals. Our current system properly balances employee taxes and employer deductions. The enormous tax write-offs successful companies sometimes enjoy are all paired with enormous tax payments by their employees. Placing new limits on tax deductibility would overtax stock and option compensation relative to wages and salaries. Tax accounting and financial accounting serve different purposes and use different principles for tracking and measuring equity compensation. From a tax perspective, there is nothing troubling if a company deducts more or less for tax purposes than it expensed on its financial accounts.

Policymakers should also keep equal treatment in mind if they consider proposals to help employees of private companies who have difficulty paying taxes when exercising options. Paying taxes is not a problem for employees of publicly traded companies who can easily sell stock to cover their tax bill. Nor is it a problem for private company employees who have other personal assets. But it is a problem for private company employees who cannot sell their shares and do not have other assets.

A recent proposal would allow these employees to defer their options income until their employer goes public or they can otherwise easily sell stock. Such deferral would ameliorate

their liquidity challenges. But it would also give stock options a tax advantage over cash wages, salaries, and bonuses. If policymakers decide to allow such deferral, they should balance it with other policies that maintain a level playing field with other types of compensation. Deferring employer write-offs is one possibility. Charging interest on deferred taxes is another.

Recipients of a special category of options known as incentive stock options sometimes face a special burden from the alternative minimum tax (AMT). Incentive stock options are typically not taxed until employees sell their stock. But gains at exercise are included as income in calculating the AMT. That extra tax burden is particularly problematic when stock prices fall. Taxpayers may discover they owe taxes on gains that have since evaporated. Lawmakers provided temporary relief from this problem in 2008. Eliminating the AMT, as many tax reforms would do, would eliminate that concern permanently.

THE BASICS OF TAXING EMPLOYEE STOCK AND OPTIONS

Employees receive equity-based compensation in four main ways: unrestricted stock, restricted stock, restricted stock units, and stock options.[i]

Unrestricted Stock

The simplest example of equity compensation is an unrestricted stock grant. The company grants shares of stock to an employee who can then hold, sell, or transfer those shares as she likes.

Unrestricted stock is taxed as compensation when the employees receives it. Employees pay ordinary income and payroll taxes on the value of the stock they receive.[ii] The business pays its portion of payroll taxes and deducts the value of the stock and payroll taxes from its taxable income.

To illustrate, suppose Esther receives 1,000 shares of unrestricted stock in the Acme Corporation. If Acme stock currently trades at $10 a share, she would owe ordinary income and payroll taxes on $10,000. Acme would owe payroll taxes on the $10,000 and would deduct $10,000 and its share of payroll taxes from its taxable income.

Unrestricted stock is thus taxed like a cash bonus of equal value. If Esther had received a $10,000 bonus, rather than stock, she and Acme would both have paid the same amounts in income and payroll taxes.

Restricted Stock

Companies usually impose restrictions on the equity they grant to employees. For example, most stock grants are subject to vesting restrictions—milestones that must be achieved before the stock irrevocably becomes an employee's property. Employees typically must stay with the

employer for a set number of months or years before their stock vests. Vesting may also depend on business performance or milestones such as going public or being acquired.

Restricted stock is taxed as compensation when it vests (unless the employee chooses accelerated taxation, discussed below). This approach makes sense because that's when the stock becomes an employee's property. Employees pay ordinary income and payroll taxes on the value of the stock they receive at vesting. The business pays its portion of payroll taxes and deducts the value of the stock and payroll taxes from its taxable income.

To illustrate, suppose Esther receives 1,000 shares of restricted stock in the Acme Corporation, vesting at the end of two years. If Acme stock trades at $15 a share after two years, she would owe ordinary income and payroll taxes on $15,000. Acme would owe payroll taxes on the $15,000 and would deduct $15,000 and its share of payroll taxes from its taxable income.

Restricted stock is thus taxed like unrestricted stock, except that the stock's value is determined on the vesting date not the grant date. Like unrestricted stock, restricted stock is taxed like a cash bonus of equal value. If Esther had received a $15,000 bonus, rather than vesting stock, she and Acme would both have paid the same amounts in income and payroll taxes.

Restricted Stock with Accelerated Taxation

Employees who receive restricted stock can choose to be taxed at grant rather than vesting.[iii] This is known as an 83(b) election, after the section of the tax code allowing it.

Under an 83(b) election, restricted stock is taxed using the same conventions as under full vesting. The employee pays income and payroll taxes, the business pays payroll taxes, and the business takes a tax deduction. The only differences are in when and how much. With an 83(b) election, tax payments and business deductions occur at grant and apply to the grant day value of the stock. Without an election, tax payments and business deductions occur at vesting and apply to the vesting day value.

Employees find 83(b) elections attractive if they believe they are likely to satisfy their vesting requirements and the stock price will rise significantly after grant. In that case, it can make financial sense to pay income and payroll taxes early in hopes of paying lower capital gains tax rates on future appreciation. Businesses, however, typically bear a corresponding tax cost because they lose the benefit of a larger income tax deduction at vesting. If the stock price declines or the employee does not satisfy vesting requirements, however, employees may regret making an 83(b) election, while employers come out ahead.

Restricted Stock Units

Employees who receive unrestricted stock become shareholders at grant. So do employees who receive restricted stock, even though their shares are not vested. These employees thus have the

same ownership rights as other owners of the same stock issue. Depending on the company, these can include rights to receive information about the company's financial condition and to vote on some corporate matters. These employees also count against regulatory limits on the number of shareholders.

Private companies often wish to limit the number of shareholders having these rights. Restricted stock units (RSUs) provide a way to do so. RSUs are not stock. Instead, they are a commitment by the employer to grant stock only when all vesting requirements are satisfied. Employees who hold unvested RSUs are not shareholders.

Restricted stock units are taxed exactly like restricted stock, with one exception. Employees who receive RSUs do not own shares at grant and thus cannot accelerate tax realization using an 83(b) election.

Stock Options

Options give employees the right to buy their employer's stock at a specified price in the future. Esther might receive 1,000 stock options, allowing her to buy shares of Acme at $10 anytime in the next 10 years. That exercise price usually equals the company's current stock price (if publicly traded) or estimated fair value (if private).[iv] As with restricted stock and RSUs, options are typically subject to vesting restrictions.

Most employee stock options are nonqualified options, meaning they do not qualify for the special treatment accorded incentive stock options (discussed below). Nonqualified options are taxed at exercise.[v] The employee pays ordinary income and payroll taxes on any gain from exercising the options. Her employer pays payroll taxes on the gain and takes a write-off against taxable income. If Acme's stock price were $15 when Esther exercised her options, for example, she would pay income and payroll taxes on her $5,000 gain. Acme would pay payroll taxes on that $5,000 and deduct that amount (plus its share of payroll taxes) from taxable income. Once again, the taxation of stock options matches the taxation of bonuses and other cash compensation.

A LEVEL PLAYING FIELD FOR CASH AND EQUITY

Stock, restricted stock, and nonqualifying options are taxed like cash compensation. Employees pay income taxes, employers get an income tax deduction, and both employees and employers pay payroll taxes.

This approach makes sense. Under a personal income tax, compensation should be taxed as income to the workers who receive it, regardless of whether it is cash, stock, or gains on exercising an option. Similarly, under a business income tax, compensation should be deductible

for the businesses that pay it, regardless of whether it is cash, stock, or option gains. Compensation is a cost of doing business and is rightly deductible.

There is no policy rationale for our tax system to favor or disfavor equity over cash wages, salaries, and bonuses. Businesses and employees should be free to design compensation arrangements that best serve their needs without unnecessary advantages or disadvantages from the tax system. A level playing field between cash, stock, and stock options allows that.

Some observers are troubled, however, by the large tax deductions that successful companies sometimes receive under this system. Facebook provides the most vivid example[1]. When the social networking giant went public in 2012, employees realized billions of dollars of gains from vesting RSUs and exercising stock options. Facebook wrote those gains off against its corporate income, reducing its federal tax liability for years. Similar, if less extreme, scenarios have played out at other successful start-ups like Twitter and at established firms like Apple. In each case, large gains for employees created correspondingly large deductions for their employers.

These high-profile deductions sparked bipartisan concern that option and RSU deductibility might be a loophole, allowing businesses to pay less than their fair share in taxes. Former Democratic senator Carl Levin of Michigan explored this issue in hearings as early as 2007. Inspired by the Facebook and Twitter initial pubic offerings, he joined with current senator Sheldon Whitehouse to sponsor legislation in 2014 to limit the amount companies can deduct to the corresponding amount reported on their financial statements. Republicans John McCain and then-senator Tom Coburn also expressed concern about deductibility, with Coburn identifying it as an example of government waste (Coburn 2013).

Several organizations have expressed similar concerns and have advocated closing what has come to be called the "Facebook loophole" or the "stock option loophole" (although it applies equally to the tax treatment of restricted stock and RSUs). Citizens for Tax Justice (2016) has done the most comprehensive work, documenting the size of these deductions at numerous publicly traded companies. Americans for Tax Fairness, a coalition of national, state, and local organizations, has recommended eliminating the "loophole" as part of a larger effort to raise revenue and make the tax code fairer.[vi] The Congressional Progressive Caucus (2017) included that proposal in its recent *People's Budget*.

These concerns are understandable given the magnitude of some business deductions for equity compensation and widespread concern about corporate tax avoidance. In this case, however, they are misplaced. The enormous tax write-offs enjoyed by some successful businesses are all paired with enormous tax payments by their employees. The federal government collects its share from employees, as it does with cash compensation. And the

[1] The Urban Institute board of trustees includes both an executive of Facebook company Instagram and a member of Facebook, Inc.'s board of directors. Neither of those trustees, nor any other board member, influenced the content or findings of this brief in any way.

federal government gives a write-off to employers, as it does with cash compensation. Current policy creates a level playing field for cash and equity compensation to employees.

Tax accounting and financial accounting use different measurement concepts and principles for equity compensation. It is inevitable that the amounts they record will differ (Walker and Fleischer 2009). The amounts companies deduct from their taxes are sometimes much larger than the compensation expenses they record on their financial statements. Financial accounting standards generally require equity compensation to be expensed based on its estimated value at the time of grant. But tax accounting focuses on the value when options are exercised or when stock vests. If a company does surprisingly well or if equity markets soar, tax deductions will be larger than accounting measures of compensation. The reverse is also true, although often overlooked. When stock prices decline, tax deductions are lower than the expenses recorded on financial statements.

Differences between tax and financial accounting measures of compensation do not raise any tax policy concerns.[vii] Placing new limits on the tax deductibility of stock and option compensation would upset the balance that our current tax system has achieved.

LIQUIDITY CHALLENGES FOR EMPLOYEES OF PRIVATE COMPANIES

Employees of private companies sometimes want to exercise stock options before their employers go public. Workers who leave a company must typically forfeit any vested options unless they exercise them within a few months. Workers who remain at a single company long enough may face a similar choice if they reach the expiration date for their options. At that point, they must either exercise or forfeit.

The decision between exercise and forfeit is easy for employees of public companies. Faced with potential forfeiture, they exercise any option whose strike price is lower than the current stock price. If necessary, they can pay any tax bill by selling some of their shares.

Employees of private companies, however, often cannot sell stock to cover their tax bill. If they have substantial amounts of other personal assets, that is not a problem. But if they do not have other financial resources to draw upon, they may decide to let valuable options expire unused. This problem has reportedly become more common in recent years, as successful start-ups have been staying private longer.[viii]

Several lawmakers recently introduced legislation to address this concern. The Empowering Employees through Stock Ownership Act would allow private company employees to defer the income they receive from exercising regular options.[ix] The deferral would last until the company's stock becomes easily sellable, up to a maximum of seven years.[x]

This deferral would ameliorate the liquidity challenge facing affected workers. But it would also create a tax advantage for stock options granted by private companies. Deferral is valuable.[xi] As long as they expect their tax rates to remain stable or go down, most employees would prefer to pay taxes later rather than today. Employees who use deferral will pay a lower effective tax rate than employees who receive comparable amounts as bonuses or receive options from public companies.

If policymakers offer deferral to private company employees, they should balance it with other efforts to maintain a level tax playing field across different types of compensation. One approach is to similarly defer any tax deduction for employers. If an employee deferred his or her option income for three years, for example, the employer would similarly defer its income tax deduction. This would partly offset any imbalance. A more complete approach would be to charge interest on any income taxes employees defer. That interest would compensate the government for allowing deferral and would help level the playing field with other forms of compensation.

INCENTIVE STOCK OPTIONS AND THE ALTERNATIVE MINIMUM TAX

A special category of stock options, incentive stock options, are taxed differently from regular stock options and restricted stock.[xii] Employees who receive ISOs do not pay taxes until they sell their stock. That may not occur until years after they exercise their options. And when they pay tax, they do so at capital gains rates rather than ordinary income and payroll tax rates. Under current law, that provides substantial savings. For people in the top income tax bracket, tax rates on capital gains are about 20 percentage points lower than on ordinary compensation.

Businesses, however, get no tax deduction at any time for any ISOs they grant. Under current law, that imposes a significant tax hit, up to 35 percent for profitable corporations.

Incentive stock options thus give tax benefits to employees and impose an extra tax burden on employers. When ISOs are granted by profitable companies, the immediate effect is an overall tax increase. Companies lose more than employees benefit. The immediate effect overstates the tax increase, however, because some companies are not profitable and because employees may defer tax payments for years. After considering all those factors, the Joint Committee on Taxation (2017) estimates that the steady-state tax burden on employers is larger than the tax benefit to recipients. Incentive stock options thus increase overall revenues, a rare example of a “negative tax expenditure” in which taxes are higher than they would otherwise be in a “normal tax system”.

That ISOs are typically taxed more heavily than regular options is not a problem in itself. Employers can always offer regular options instead.

But there is legitimate concern about how the alternative minimum tax applies to ISOs. Under the regular tax system, ISO gains are taxed when the employee eventually sells his or her shares. The AMT, however, taxes them at AMT rates at exercise. This can surprise employees who expect ISO gains to be taxed only when they sell their stock. And it can impose a particular burden when stock prices fall. Employees may discover they owe AMT taxes on gains at exercise that have since evaporated. In 2008, lawmakers provided temporary relief to taxpayers who found themselves in this situation.[xiii] A more permanent solution would be to eliminate the AMT, as proposed by many tax plans, or to remove ISOs from the list of AMT preference items.

CONCLUSION

America's tax system has many flaws. The basic way we tax employee stock and options is not one of them. Current practice creates a level playing field between cash compensation for employees and most forms of stock and option compensation. Employees pay income taxes on their gains when stock vests or they exercise most options. Businesses get a corresponding tax deduction. And both employees and businesses pay payroll taxes. Policymakers should maintain that balance in any reform.

NOTES

[i] This brief focuses on stock and options employees receive through arm's-length compensation agreements; for further details, see Adkins (2013) and Bickley (2012). Equity compensation to founders and large shareholders raises additional issues (Toder 2017). Reasonable compensation requirements are necessary, for example, to ensure new equity grants to large shareholders do not create a tax shelter. Additional issues also arise for equity compensation received by fund managers who invest in companies (Marron 2016).

[ii] Employees sometimes pay a discounted price for their stock. In those cases, taxes are based on the difference between the stock's fair value and the price paid.

[iii] Unless their employer's stock plan prohibits such early recognition.

[iv] If an option's exercise price at grant is below the stock's fair market value, the employee is liable for taxes when the option vests, rather than at exercise. Those taxes include regular income taxes, payroll taxes, and an additional penalty, all applied to the spread between fair market value on the vesting date and the exercise price (Cvach, Rhodes, and Friedman 2015).

[v] With one exception: nonqualified options may be taxed at receipt if they have a "readily ascertainable fair market value." This is very rare (Cvach, Rhodes, and Friedman 2015).

[vi] Americans for Tax Fairness, letter to members of the Senate Finance Committee, April 15, 2015, https://www.finance.senate.gov/imo/media/doc/Americans%20for%20Tax%20Fairness.pdf.

[vii] Unexpected changes in business performance and stock valuations are the primary cause of differences between book and tax measures of equity compensation. In some cases, however, a third factor may also be at play. To boost reported earnings, some businesses may underestimate the reported costs of equity compensation. That is a significant concern for financial accounting, but is not a tax issue.

[viii] Scott Kupor, "The Lack of Options for (Startup Employees') Options," Andreessen Horowitz, June 23, 2016, http://a16z.com/2016/06/23/options-timing/.

[ix] The same issue can arise with restricted stock units, to which the legislation would also apply. But RSUs often have liquidity conditions as part of vesting.

[x] Deferral would be subject to various limitations. Qualifying equity plans must apply to at least 80 percent of employees. Deferral is not available to the chief executive officer, the chief financial officer, their relatives, any of the four highest-paid employees, or significant equity owners. See Empowering Employees Through Equity Ownership Act, S. 1444, 115th Congress (2017).

[xi] This discussion focuses on the time value of deferring tax payments. Employees with varying income and sufficient liquid assets could also use deferral for strategic timing, aiming to realize option income in periods when they face lower tax rates.

[xii] Incentive stock options are less common than regular options and RSUs. One reason is the higher combined (employee plus employer) tax rate they typically face. Another is that they are subject to restrictions. Incentive stock options are available only to employees, not independent contractors or other service providers. The underlying stock exercisable in any given year can be no more than $100,000. Incentive stock options for large shareholders (more than 10 percent) must have exercise prices at least 110 percent of fair market value and cannot last more than five years. And ISOs convert into the equivalent of regular stock options if employees do not hold stock for at least one year after exercise and two years after grant.

[xiii] The Emergency Economic Stabilization Act of 2008, the act that created the Troubled Asset Relief Program, gave AMT relief for workers who had exercised incentive stock options only to see the value of their stock plummet.

REFERENCES

Adkins, Eddie. 2013. "Taxation of Stock Options and Restricted Stock: The Basics and Beyond." Presentation given at the 44th Maryland Association of Certified Public Accountants Chesapeake Tax Conference, Baltimore, MD, September 16–17.

Bickley, James M. 2012. "Employee Stock Options: Tax Treatment and Tax Issues." Washington, DC: Congressional Research Service.

Citizens for Tax Justice. 2016. "Fortune 500 Corporations Used Stock Option Loophole to Avoid $64.6 Billion in Taxes Over Past Five Years." Washington, DC: Citizens for Tax Justice.

Coburn, Tom. 2013. *Wastebook*. Washington, DC: United State Senate.

Congressional Progressive Caucus. 2017. The People's Budget: A Roadmap for the Resistance FY 2018. Washington, DC: United States House of Representatives.

Cvach, Gary, Carolyn Rhodes, and Steven Friedman. 2015. Stock Option Compensation—Warnings for the Unwary. Washington, DC: KPMG, LLP.

Joint Committee on Taxation. 2017. Estimates of Federal Tax Expenditures for Fiscal Years 2016–2020. Washington, DC: Joint Committee on Taxation.

Marron, Donald. 2016. "Goldilocks Meets Private Equity: Taxing Carried Interest Just Right." Washington, DC: Urban-Brookings Tax Policy Center.

Rosenberg, Joseph, and Donald Marron. 2015. Tax Policy and Investment by Startups and Innovative Firms. Washington, DC: Urban-Brookings Tax Policy Center.

Toder, Eric. 2017. "Taxing Entrepreneurial Income." Washington, DC: Urban-Brookings Tax Policy Center.

Walker, David I., and Victor Fleischer. 2009. "Book/Tax Conformity and Equity Compensation." *New York University Tax Law Review* 62:399–444.

The Tax Policy Center is a joint venture of the
Urban Institute and Brookings Institution.

BROOKINGS

For more information, visit taxpolicycenter.org
or email info@taxpolicycenter.org

Copyright © 2017. Urban Institute. Permission is granted for reproduction of this file, with attribution to the Urban-Brookings Tax Policy Center.