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Incentive Stock Option Plans

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This column compares the accounting and tax treatments of compensatory stock option plans qualified as incentive stock options (ISOs) and shows the linkage of these treatments in the deferred tax accounts. Effective in 2006, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123(R), "Share-Based Payment," calls for the expensing of stock option compensation. The compensation cost is measured on the date of grant, reflecting an expense over the service period of the employees affected, and is based on the fair value as computed using an option-pricing model such as Black-Scholes.

Before SFAS No. 123(R) was issued, accounting for compensatory stock options was governed by Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," from 1972. Under the application of that Standard, no compensation expense was generally reflected in net income for stock options because these options usually had an exercise price equal to their market value on the grant date and, thus, had no intrinsic value. The pro forma effects on net income were provided in a footnote to the financial statements.

Sections 421-424 of the Internal Revenue Code (IRC) govern the income tax treatment of ISOs. To be qualified as an ISO, the plan must have the following characteristics:

- It has to be approved by the shareholders within 12 months before or after adoption (§422(b)(1)).
- The options have to be granted within the earlier of 10 years after plan adoption or the date of shareholders approval (§422(b)(2)).
- The option must be exercisable within 10 years of the grant date (§422(b)(3)).
- The option price may not be less than the fair value of the stock on the date of grant (§422(b)(4)).
- The option must be nontransferable other than by will or the laws of descent and distribution (§422(b)(5)).
- The individual receiving such option can't hold more than 10% of the voting power in the corporation on the grant date (§422(b)(6)).

An entity generally may deduct the value of the stock options in the year the option is included as compensation for the employee in question. But the exercise of the options and the holding of stock that satisfy the ISO requirements won't be taxable until the stock is sold by the recipient. Accordingly, there will be no deduction for the company.

Should the employee sell the stock received from exercising the ISO, the difference between exercise price and selling price is treated as a capital gain or regular income, depending on the length of the holding period (IRC §421(b)). If the employee satisfies the holding period requirements, the employee receives capital gain treatment, and the corporation doesn't receive a deduction. If the holding period requirements aren't satisfied, the gain is treated as ordinary income (compensation), and the employer receives a deduction. Stock compensation expense stemming from an ISO represents a permanent accounting/tax difference producing no deferred tax effects since it's unlikely there will be a future tax deduction for the employer or future income to the employee.

To sum up, compensatory stock option plans are expensed for accounting over the service periods required before the options can be exercised. In taxation, there is usually no deduction for the exercise of such options because the employee will normally hold the stock for a sufficient time period to satisfy the ISO holding requirements: When the employee sells the stock, the difference between the selling and exercise prices is a capital gain, and the employer doesn't have a tax deduction. If the ISO requirements aren't met, however, that difference will be ordinary income to the employee, and the employer does have a tax deduction. The following example applies to the accounting for the tax consequences of stock options:

Assume one million option shares are granted. If the estimated fair value of the option is $6 based on Black-Scholes, the total compensation would be $6 million. This will be allocated over the service life, which we will assume is three years. The accounting expense in each year would be $2 million. Under an ISO, there typically would be no tax deduction. As a result, a permanent difference would exist between accounting and taxation for the compensatory stock option plan.

Finally, an exercise of a stock option plan today might include options granted prior to implementation of SFAS 123(R), and, as such, neither book nor tax expenses were recorded. Any tax deductions allowed from the exercise of these options represent permanent differences between financial accounting and income taxation, which don't generate deferred tax effects. ■

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