Iso disqualifying disposition tax reporting

For small businesses engaged in the practice of offering incentive stock options (ISO) to regular employees who meet certain criteria, certain W-2 reporting requirements may be required. Whether a W-2 report is required depends on when the employee sells the stock in relation to when the employee became eligible for the options and when the stock was actually purchased. The Payroll Source describes that it is not uncommon for companies to offer certain employees the opportunity to buy shares of their company's stock at a fixed interest rate per share that is often below the fair market value of the stock. Furthermore, the worker is not obliged to pay taxes on the difference between the price of the selector and the actual price. A provision is defined as the time at which the employee sells the shares. According to the Payroll Source, a special disposal is a sale of shares that meets two specific conditions. First, the sale of shares may not take place less than two years after the point at which the employee is able to purchase the stock, even if he does not do so immediately at the time of eligibility. The other requirement is that the stock must be held for at least one year after the purchase of the stock. For example, if an employee becomes eligible to buy the stock in January 2009 and does so in March 2010, they must keep the stock until March 2011 for any sale to be special disposal. This is because the two-year eligibility requirement will expire in January 2011 and the one-year retention requirement will be met in March 2011. The advantage to selling as a special disposal is that income is not referred to in W-2 as taxable income and is simply taxed at the capital gains rate that is usually lower than it would be for normal income. If one of the two conditions mentioned in the Payroll Source is not met, the sale is a rejection provision. The income earned by the employee must be referred to in box 1 of W-2. Box 1 is federal taxable income. The rejection provisions are not subject to Social Security or Medicare tax. Therefore, the amount of the benefit should never be mentioned in box 3 or 5. The disposal amount is usually posted in box 14 and is displayed as ESPP. Whether the employee who exercised and subsequently sold the stock is terminated does not matter, as it relates to how the W-2 report is handled. If the employee does not meet the required occupancy requirements noted by The Payroll Source, then the income must be reported in W-2 as taxable for federal income tax, but no deduction should be made when the amount is recorded. Howard Wagner, CPA A recent principal counseling counsel (CCA 201519031) provides guidance on rejecting disposals of incentive stock options (ISAs) in reorganizations. The holder of an ISO that meets the requirements of Law 422 generally does not recognise the income in the exercise (although the holder of the minimum tax adjustment). Accordingly, the employer does not receive a discount in the exercise of the ISO. If the stock acquired by exercising the ISO reserve is maintained until not later than one year from the date of exercise of the option or two years from the date of granting the option, any profit from the disposal of the ISO reserve shall be entitled to be regarded as a long-term capital gain (Article 422(a)(1)). A provision generally includes a sale, exchange, gift, or transfer of legal title, but does not include a transfer from a decision-make to a property or a transfer with a bequest or inheritance; exchange to which points 354, 355, 356 or 1036 apply (or so much of sec. 1031 as regards sec. 1036); or simple pledge or pledge (Article 424(c)(1)). If the ISO stock is allocated before the holding period is respected, it is a disposal (Article 421(b)), which results in W-2 wages for the employee and an income tax deduction for the company. However, wages are not subject to federal insurance contribution law taxes, federal unemployment tax law taxes, or wage withholding. CCA 201519031 investigated the application of the rejection rules in two scenarios: Scenario 1 includes a transaction characterized as a booted sec. 368 reorganization, and scenario 2 deals with a reorganization that failed to qualify for sec. 368. The following are from CCA: Scenario 1: Corporation X and Corporation Y are unrelated companies incorporated in accordance with the laws of State B. On July 1, 2011, Corporation X grants an option to A, an employee of Company X as of January 4, 2011, with A's right to purchase 100 shares of Company X with voting common shares for $15 per share. The stock option is classified as ISO, as defined in 422nd place. On December 30, 2011, A exercises the option when the fair market value (FMV) of The Corporation X share is $25 per share and 100 shares of Company X voting common shares are transferred to A on that date. On January 3, 2012, Corporation X and Corporation Y concluded an agreement (the merger agreement) under which Corporation Y will acquire Corporation X by forming a new subsidiary (Corporation Z) that will merge with and with Company X, with Company X surviving. Under the merger, any outstanding share of Company X voting common shares will be converted into one share of Company Y with voting common shares with a value of $25 and $1.50 in cash. The exchange shall not result in the distribution of a dividend in accordance with paragraph 356(a)(2). Company Z's share will be converted into common shares with the right to vote of Company X. Company G merges into X in a transaction classified as a reorganisation described in paragraph 368(a) (1)(A) due to position 368(a)(1)(E). Following the merger, Corporation X continues to be a 100 % subsidiary of Company Y. As of 4 January 2011, A and Corporation X have maintained an ongoing employment relationship, and on 1 August August, August, A sells the 100 shares of Company Y share for $40 per share. Scenario 2: Assume the same facts as in Scenario 1, except that each share of Company X common shares is converted into one share of Company Y common shares with a value of $16.50 and $10 in cash. The transaction does not meet the requirements of 368(a) (2) (E) point (ii) because the shareholders of Company X did not exchange shares of Company Y of Company X that are a control (80%) company X, but instead exchanged more than 20% of Company X's shares for cash. Therefore, the transaction cannot be regarded as a reorganisation in accordance with Article 368(a)(1)(A) because of Article 368(a)(2)(E) or any other provision of Law 368(a). Analysis scenario 1: CCA concluded that no foreclosure mood had occurred as there had been no disposal of the stock, although $150 of profit was recognized as a result of the $1.50 of the start-up received in relation to the 100 Corporation X shares exchanged. (The debate as to whether the start-up constitutes goodwill or a dividend in accordance with paragraph 356(a)(2) does not fall within the scope of this point.) The receipt of inventory and start-up acquired in a reorganisation sec. 368 is governed by paragraph 356 and therefore does not constitute the disposal of the ISO stock in accordance with paragraph 424(c)(1)(B), even though the holder of the ISO stock recognises a profit. The stock received in the reorganisation stages in the shoes of the original ISO stock for the purposes of the exclusion disposal rules (Article 424(b)). When the owner of the ISO share then sells the stock for $40 per share on August 1, 2013, 19 months after acquiring it by ISO exercise, the result is a special disposal. The employee acknowledges a long-term capital gain of $2,500 on the sale of his or her 100 shares ($40 per share revenue minus base of $15 per share). Scenario 2: The transaction cannot be classified as a reorganization in accordance with status 368 and therefore neither sec. 354 nor sec. 356 apply to the exchange. On the contrary, the exchange of ISO shares for shares and cash is a taxable exchange under sec. 1001, and there is a rejection mood. The total profit recognized by the employee in the 100 shares is $1,150 ($26.50 per share revenue minus $15 per share). Due to foreclosure disposal, the employee's $1,150 profit has two components on the date of the failed reorganization: $1,000 of ordinary W-2 income wages and $150 of short-term capital gain. W-2 income from the exclusion order is based on the excess of the share's FMV compared to the exercise price at the exercise date. The 100 options were exercised for $15 per share at a time when FMV's stock was $25 per share The disposal rejection leads to $1,000 of W-2 wages for the employee ($10 per share profit at the exercise date multiplied by 100 shares). After rejecting the disposal, the employee's base of 100 shares of ISO share is $2,500, and an additional $150 of profit is when the shares sold for $2,650 in the failed reorganization. When the employee then sells the stock for $40 per share, or $4,000, on August 1, 2013, the result is $2,350 of short-term capital growth. If Sec. 368 is reorganized, the acquiring company should continue to monitor employees' holdings in ISO shares. In Scenario 1, the disposal of an employee's shares on August 1, 2013, constitutes a special disposal of ISO shares, because the stock received in the sec. 368 reorganization is still treated as an ISO stock. However, if the employee had sold all of his or her shares on November 15, 2012, the result would still be a dismissive mood. EditorNotes Howard Wagner is director with Crowe Horwath LLP in Louisville, Ky. For more information on these items, contact Mr. Horwath LLP in Louisville, Ky. Wagner at 502-420-4567 or howard.wagner@crowehorwath.com. Unless otherwise stated, contributors are members or affiliated with Crowe Horwath LLP. Llp.