

STOCK OPTIONS

WHAT ARE EMPLOYEE STOCK OPTIONS?

An employee stock option is the right or privilege granted by a corporation to an employee to purchase the corporation's stock at a specified price during a specified period.

Those stock option plans that meet the requirements of Sections 421 through 424 of the Internal Revenue Code (IRC) are referred to as statutory stock options; those that do not are referred to as nonstatutory or nonqualified stock options (NSO).

The determination whether a stock option plan meets the requirements of the IRC are made by the Internal Revenue Service (IRS).

California's employment tax treatment of stock options conforms to the federal tax treatment, which has evolved through court decisions, IRS rulings and notices, and amendments to the IRC.

In addition to statutory and nonstatutory stock options defined in the IRC, there is also a California Qualified Stock Option, which must meet the requirements of Section 17502 of the Revenue and Taxation Code (R&TC).

The following discussion defines the various types of stock options and provides a detailed explanation of California's employment tax treatment of income derived from stock options.

The attached one-page summary table is provided for quick reference.

STATUTORY STOCK OPTIONS

There are two types of statutory stock options:

- Incentive Stock Options (ISO), which must meet the requirements of Section 422 of the IRC and are usually intended for "key" employees as defined by the IRC. The gain from the exercise of an ISO is based on the spread income (the difference between the fair market value of the stock when the option is exercised, less the cost to the employee).
- Employee Stock Purchase Plans (ESPP), which must meet the requirements of Section 423 of the IRC and are usually intended for "rank and file" employees. The gain from the exercise of an ESPP is based on both the spread income and the discount portion of the stock (ESPPs may be granted with an option price below the full fair market value of the stock as of the date granted, but this discount may not exceed 15 percent).

The employment tax treatment of a statutory stock option depends, in part, upon when the employee disposes of (sells, exchanges, gifts, or transfers) the stock acquired through the exercise of the option. Stock that is disposed after a required minimum holding period is said to have a "qualifying disposition." Stock not held for this period is said to have a "disqualifying disposition." Stock disposed to comply with conflict-of-interest requirements is an exception to the minimum holding period.

Employment Tax Treatment of Statutory Stock Options

California's employment tax treatment of the income realized from a statutory stock option is the same as the federal treatment: no income results from the grant or exercise of the stock option. Any gain from the sale of stock is a capital gain, not wages, and it is not subject to employment taxes: Unemployment Insurance (UI), Employment Training Tax (ETT), State Disability Insurance* (SDI), and Personal Income Tax (PIT) withholding.

Note: Although no employment taxes are required, in cases where there has been a disqualifying disposition of a statutory stock option, the gain from the spread income (and the discount portion of stock acquired by the exercise of an ESPP) must be reported as PIT wages on the *Quarterly Contribution Return and Report of Wages (Continuation)* (DE 9C).

NONSTATUTORY STOCK OPTIONS

As stated above, an NSO is an employee stock option that does not meet the requirements of Sections 421 through 424 of the IRC. Consequently, it does not enjoy the same favorable tax treatment as a statutory stock option.

Employment Tax Treatment of Nonstatutory Stock Options

When an NSO is subject to tax depends on whether, at the time the option is granted, the stock has a "readily ascertainable" fair market value. This is determined by Section 83 of the IRC and corresponding federal regulations.

- Income resulting from an NSO that has a fair market value at the time it is granted is considered wages for California employment tax purposes and is subject to UI, ETT, SDI, and PIT withholding and reportable as PIT wages at the time the option is **granted**.
- Income resulting from an NSO that did not have a readily ascertainable fair market value at the time it was granted is wages for California employment tax purposes and is subject to UI, ETT, SDI, and PIT withholding and reportable as PIT wages at the time the option is **exercised**.

Note: Most NSOs do not have a readily ascertainable fair market value at the time they are granted.

CALIFORNIA QUALIFIED STOCK OPTIONS (CQSO)

Section 17502 of the R&TC provides that a stock option specifically designated as a CQSO will receive the favorable tax treatment provided by Section 421 of the IRC if all the following conditions are met:

1. The option was issued on or after January 1, 1997, and before January 1, 2002.
2. The earned income of the employee to whom the option is issued does not exceed \$40,000 in the tax year in which the option is exercised.

* Includes Paid Family Leave (PFL).

3. The number of shares of stock granted in the option does not exceed 1,000 and the combined fair market value of the shares is less than \$100,000 at the time the option is granted.
4. The employee must be employed by the company at the time the option is exercised (or within three months of that date), or within one year if permanently and totally disabled.

Employment Tax Treatment of CQSOs

For federal purposes, CQSOs are subject to federal employment taxes in the same manner as an NSO (see above).

For California employment tax purposes, a qualified CQSO receives the favorable tax treatment of a statutory stock option (see above). However, there is no minimum holding period for a CQSO, so there can be no disqualifying disposition. As a result, PIT wages are never reportable upon the disposition of stock obtained through a CQSO.

STOCK OPTIONS TRANSFERRED IN A COMMUNITY PROPERTY SETTLEMENT

In California, a stock option granted during the period of a marriage (or, effective January 1, 2005, during a registered domestic partnership) is community property. Any stock option transferred in a community property settlement is an NSO, either because it did not qualify as a statutory stock option initially or by virtue of the transfer. If a statutory stock option is transferred due to a divorce or pursuant to a domestic relations order, the option no longer qualifies as a statutory stock option as of the day of the transfer. Thereafter the option is treated as an NSO.

When an NSO is transferred to the nonemployee spouse/partner as part of a community property settlement, there is no income to either party until the nonemployee exercises the option. When the option is exercised, the income is subject wages for UI, ETT, SDI, and PIT withholding purposes. However, the income is not reportable as PIT wages.

The employee's ex-spouse (or former registered domestic partner) realizes income based on the employee's services. The employer should report the income as follows, based on the requirements established by the IRS in Revenue Rulings 2002-22 and 2004-60:

- *Employee:* The income is reportable on behalf of the employee for California UI, ETT, and SDI purposes since it resulted from the employee's prior services. However, the income is not subject to PIT withholding and is not reportable as PIT wages for the employee.
- *Ex-spouse or former registered domestic partner:* The income is reportable as nonemployee compensation on federal Form 1099-MISC. California PIT withholding is required, but the income is not reportable as PIT wages.

MULTISTATE JURISDICTIONAL ISSUES

Stock options, as explained above, may not immediately become "wages" subject to taxation. An employee may be granted an option in one state, exercise the option in a second state, and dispose of the stock in a third state. For UI, ETT, and SDI purposes, wages derived from the exercise of a stock option are subject to the jurisdiction of

the state in which services are otherwise subject at the time the "wages" are paid (when the option becomes taxable).

For California PIT purposes, wages derived from stock options are allocated between the states in which the employee performs services for the employer that grants the option. This allocation begins when the option is granted and ends when the income derived becomes taxable.

For California Residents, all taxable wages resulting from stock option transactions are to be reported to the Employment Development Department (EDD) as PIT wages regardless of where the services that generated the wages were performed. If the same wages are taxed in another state, then the California PIT withholding required is reduced by the amount of state income tax withheld and paid to the other state. If the employee is not a resident of California, then only the wage allocated to California must be reported to the EDD and are subject to California PIT withholding.

Example - California Resident

On March 1, 2009, your company grants nonstatutory stock options to an employee who is a resident of Michigan. On June 1, 2011, the employee is transferred to your California location and takes up permanent residency in California. On August 1, 2011, the employee exercises the options.

Because the employee is a California resident, the wages resulting when the nonstatutory stock options are exercised (difference between the fair market value of the shares on August 1, 2011, and the option price) must be reported to the EDD and are subject to California PIT withholding. If the wages are also subject to state income tax withholding by Michigan, then the amount of California PIT withholding required is reduced by the amount of state income tax withheld and paid to Michigan.

Example - Nonresident

An employee is granted an NSO (without a readily ascertainable fair market value) for services performed in California employment. The employee retires and moves to Nevada, where he exercises his option.

In this case, the spread income is subject to UI, ETT, and SDI in California because the services that resulted in the stock option were localized in California. Similarly, for PIT withholding and wage reporting purposes, because all the employee's services were performed in California, the income (and tax thereon) is allocated exclusively to California.

ADDITIONAL INFORMATION

For further assistance, please contact the Taxpayer Assistance Center at 888-745-3886 or visit the nearest Employment Tax Office listed in the *California Employer's Guide* (DE 44) and on the EDD website at www.edd.ca.gov/Office_Locator/.

The EDD is an equal opportunity employer/program. Auxiliary aids and services are available upon request to individuals with disabilities. Requests for services, aids, and/or alternate formats need to be made by calling 800-745-3886 (voice), or TTY 800-547-9565.

This information sheet is provided as a public service and is intended to provide nontechnical assistance. Every attempt has been made to provide information that is consistent with the appropriate statutes, rules, and administrative and court decisions. Any information that is inconsistent with the law, regulations, and administrative and court decisions is not binding on either the Employment Development Department or the taxpayer. Any information provided is not intended to be legal, accounting, tax, investment, or other professional advice.

Employment Tax Treatment of Stock Options

Federal Employment Tax Treatment

California Employment Tax Treatment

Type of Stock Option	FUTA	FICA	Federal Income Tax Withholding	UI/ETT/SDI	PIT Withholding	PIT Wages
Statutory Stock Option Includes Incentive Stock Option (ISO) and Employee Stock Purchase Plan (ESPP) Qualifying Disposition Disqualifying Disposition	Not subject ¹ Not subject ¹	Not subject ² Not subject ²	Not subject ³ Not subject ^{4,5}	Not subject Not subject	Not subject Not subject	Not reportable Reportable when disposed
Nonstatutory Stock Option (NSO) With Readily Ascertainable Fair Market Value When Granted Without Readily Ascertainable Fair Market Value When Granted	Subject when granted ^{6,7} Subject when exercised ^{7,8}	Subject when granted ^{6,7} Subject when exercised ^{7,8}	Subject when granted ^{6,7} Subject when exercised ^{7,8}	Subject when granted Subject when exercised	Subject when granted Subject when exercised	Reportable when granted Reportable when exercised
California Qualified Stock Option (CQSO) Must meet all the requirements of R&TC, Section 17502 of the R&TC. If the requirements are not met, the CQSO will receive NSO treatment for California employment tax purposes. See NSO above.	See NSO above	See NSO above	See NSO above	Not subject	Not subject	Not reportable

¹ IRC, Section 3306(b)(1)

² IRC, Section 3121(a)(22)

³ IRC, Section 421(a)

⁴ IRC, Section 421(b)

⁵ IRC, Section 423(c)

⁶ IRC, Section 83(a)

⁷ Code of Federal Regulations, Title 26, Section 1.83-7(a)

⁸ IRC, Section 83(e)(3)