ESPP – Stock Cost Basis

Employee Stock Purchase Plan (ESPP)

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Posted Tue, January 26, 2016

One of the toughest things to determine is the cost basis of stock that was acquired under a stock option plan, a stock grant, or an employee stock purchase plan (ESPP). This can prove problematic since taxes might be overpaid if cost basis is not correctly computed and your ESPP capital gains will be artificially increased.

The theory on basis in general is that you cannot create basis without paying income taxes on that income. For example, if you pay $100 for Apple stock and later sell it for $150 you had a $50 gain since the $100 was already taxed when you earned it. Another example are rental properties- when you buy ahouse for $100,000, live in it for 3 years, and later make it a rental you cannot increase the basis to the fair market value. This would artificially reduce your gain when you later sell it because of the manufactured step-up in basis (basis that you did not pay an income tax on).

Yet another example are small business owners. At times a small business owner will claim he or she injected intellectual property into a business and it suddenly has a $100,000 value upon inception. This is impossible unless the business owner picks up $100,000 in taxable income at the same time. Again, you cannot manufacture basis- if this same business owner later sold his or her business for $500,000 he or she should have a $500,000 gain, and not $400,000 based on a manufactured basis.

Make sense? Good, here are the rules on determining the cost basis for various types of stock options.

Disqualifying Dispositions

There are also two dispositions (sale) of the stock, and are blandly referred to as qualifying and non-qualifying which can dictate how the gain is calculated and treated. This is common within the ESPP stock option and will affect your ESPP tax treatment. To have a qualifying disposition, you must not sell the stock for two years after the stock option was granted (awarded) to you and you must have held the stock for one year.

For example, you work for a company with an employee stock purchase program (or employee stock purchase plan depending on office vernacular). Assumptions-

Grant/Award	July 1 2014
Exercise	May 1 2015
Sold	May 1 2015

This would be an ESPP disqualifying disposition. You didn’t hold the stock for more than one year and the time between grant/award date was under two years.

Same example, but you held the stock until May 1 2016-

Grant/Award	July 1 2014
Exercise	May 1 2015
Sold	May 1 2015

This still disqualifies since you did not hold the stock more than two years from grant/award date.

Quick Reference Table

Exercise/Discount Price	$40
Market Price	$50
Number of Shares	100
Sale Proceeds	$5,000

Disposition
Proceeds
Actual
Cost Basis
Ordinary
Income
Long-Term
Cap Gain
Short-Term
Cap Gain
ISOs
Non-Qualifying

Qualifying

Hold
$5,000

$5,000

NA
$5,000

$4,000

$4,000
$1,000

$0

NA
NA

$1,000

Only when sold
NSOs
Non-Qualifying

Qualifying

Hold
$5,000

$5,000

NA
$5,000

$5,000

$5,000
$1,000

$1,000

$1,000
NA

$0

Only when sold
$0

NA

NA
ESPPs
Non-Qualifying

Qualifying

Hold
$5,000

$5,000

NA
$4,000 + Ordinary income

$4,000

$4,000
Lessor of the discount or profit*

$0

NA
NA

$1,000

Only when sold
$0

NA

NA
RSUs
NA
$5,000
$5,000
$5,000
NA
NA* In this example, the discount was $1,000 ($10 x 100 shares) and the profit was $1,000 (paid $40, sold for $50, x 100 shares).

Observe that the 1099-B in all the disposition examples will probably show $4,000. This is a rule change starting in 2014. It decreased the communication workload between employers and brokers. Therefore, adjustments must be made on Form 8949 for an increase in basis. In other words, always check the amount of ordinary income (compensation element) being presented on a W-2. Basis was increased since income was calculated and taxed in connection with the stock option.

Tax Problems

As mentioned earlier with the table examples, 1099-Bs might not accurately reflect the true cost basis. Grant paperwork, Forms

3921 and 3922 and other source documents must be reviewed.

Another problem occurs with recordkeeping. For example, an employee might purchase stock October 1 through an ESPP and sell it March 1 the following tax year. This is a non-qualifying disposition, yet because it was an ESPP the purchase of the stock on October 1 did not trigger an ordinary income tax event that the employer could monitor. In this case, the calculated amount (lessor of the discount or profit) must be added to line 7 of Form 1040.

Forms 3921 and 3922

These forms are used by employers to report stock transfers. Form 3921 is used for incentive stock options which qualify for favorable tax treatment, and Form 3922 is used for employee stock purchase plans. They are very similar and contain a ton of good information such as-

Box 1	Date Option Granted
Box 2	Date Option Exercised
Box 3	Fair Market Value Per Share on Grant Date
Box 4	Fair Market Value Per Share on Exercise Date
Box 5	Exercise Price Paid Per Share
Box 6	Number of Shares Transferred
Box 6	Number of Shares Transferred
Box 7	Date Legal Title Transferred
Box 8	Exercise Price Per Share Determined as if the Option Was Exercised on the Date Shown in Box 1. If the exercise price per share was not fixed or determinable on the date of grant entered in box 1, the amount in Box 8 will be the exercise price per share determined as if the option was exercised on the date of grant entered in box 1. If the exercise price per share is fixed or determinable on the date of grant entered in box 1, then Box 8 is blank.

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