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Tax treatment of stock options

THERE are many ways by which a company can provide incentives, rewards or benefits to its employees. One of these is the granting of a stock option.

A stock option is a right granted by an employer to an employee to buy shares of the company or its affiliates. There are various characteristics of a stock option, such as with respect to the employees or group of employees who are entitled to the option; the number of years before an employee can be granted the right to exercise the option; and the percentage or number of shares the employee can acquire. There are also various reasons employers are granting stock options to their employees. But regardless of the conditions for the exercise of the option and the employer's reasons for granting it, there is normally a benefit on the part of the employee when he or she exercises that right.

Aside from becoming a stockholder of the corporation or its affiliate, the employee acquires the shares at a preferential price. The exercise price of a stock option is usually lower than the prevailing market price of the shares. This lowered price is, by itself, a benefit. But there had been inconsistent treatment from the tax authorities of this discount or the difference between the actual exercise price and the market price.

In one ruling, for instance, the Bureau of Internal Revenue (BIR) ruled that employees are not required to pay income tax on the difference between the acquisition cost and market value at the time of exercising the stock option or of the purchase of the shares. The reason is that no income or flow of wealth is actually or constructively realized or received from the acquisition of the shares, despite the granting of a discount.

In another ruling, though, the BIR noted that the employee benefits from the lower exercise price. If the employee buys shares in the market, he or she would be paying at the prevailing market price. But by exercising the stock option, he or she receives a benefit equivalent to the difference between the exercise price and the market value of the shares at the time of the exercise. The BIR confirmed that there is a fringe benefit subject to the fringe-benefit tax, to the extent that the exercise price is lower than the fair-market value of the underlying shares at the time of the employee's exercise of the option.

In a third ruling, the BIR considered the difference between the exercise price and the market value of the shares as an income or gain. And this income or gain derived by the employees from their exercise of the stock option was considered as additional compensation subject to income tax and, consequently, to the withholding tax on compensation.

Probably noting this inconsistency in the treatment of the benefits derived from the exercise of stock options, the BIR issued Revenue Memorandum Circular 088-12 to clarify the tax implications of income or gain derived by an employee from the exercise of stock options. Under this circular, any income or gain derived from stock-option plans granted to managerial and supervisory employees, which qualifies as fringe benefits, is subject to the fringe-benefit tax. The additional compensation or the taxable fringe benefit is the difference of the book value/fair-market value of the shares, whichever is higher, at the time of exercise of the stock option and the price fixed on the grant date. But the option only has value if, at the time of the exercise, the stock is worth more than the price fixed on the grant date. The additional compensation or taxable fringe benefit arises when the shares of stocks involved are that of a domestic or foreign corporation.

The tax imposed on the employer or employee at the time of the exercise of the stock option is different from the tax imposed in case of a subsequent sale of the shares. The usual capital-gains tax will apply if the shares involved are shares of stock in a domestic corporation that are not traded in the stock exchange, while the stock-transaction tax will apply if the shares involved are shares of stock that are listed and traded through the local stock exchange. For shares of stock in a foreign corporation, the gain is subject to ordinary income tax.

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The author is a junior associate of Du-Baladad and Associates Law Offices (BDB Law), a member-firm of the World Tax Services Alliance.

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