

Incentive Stock Options

Topic:	Incentive stock options (ISOs) explained
Author:	Terry L. Kaul, CFP
Sponsor:	Vantage Financial Partners Limited
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Executive Summary:	ISOs differ from nonqualified options and the differences are explained along with the tax consequences. ISO's are subject to Alternative Minimum Tax and this causes tax traps for the unwary.

Incentive stock options (ISOs) are a form of equity compensation that provides unique tax benefits — and significant tax complexity. They aren't as widely used as nonqualified stock options, but a substantial number of executives will find their companies offering them. Nonqualified options have two disadvantages compared to incentive stock options. One is that you have to report taxable income at the time you exercise the option to buy stock, and the other is that the income is treated as compensation, which is taxed at higher rates than long-term capital gains (and is subject to payroll taxes). Incentive stock options provide a way to avoid both of those disadvantages. There's no income to report at the time you exercise the option (unless you sell the stock at the same time you buy it). And if you hold the stock long enough to satisfy a special holding period, your gain from the stock will be treated as long-term capital gain.

These tax advantages are partly offset by the *alternative minimum tax* (AMT). This is a rather complicated calculation that may cause you to pay tax at the time you exercise an ISO. But the amount of AMT you pay is less than the tax you would have paid if you exercised a nonqualified option — and you may be able to recover much or all of the your AMT payment by claiming an *AMT credit* in future years.

How You Get Them

Incentive stock options must be granted pursuant to a *stock option plan* that was adopted by the company's board of directors and approved by the shareholders. The board of directors, or a committee appointed by the board (usually called the *compensation committee*), may decide who receives the awards and the specific terms of the options. In some cases options are granted according to a formula.

What You'll Receive

When a company grants an option it should provide certain documents. You should receive an *option agreement*, setting forth the specific terms of your option, and a copy of the plan, which provides some general rules that govern all options. In many cases the company also provides a summary of the plan. It's important to understand your rights under the agreement and the plan. You need to know:

- ❖ What is the earliest date you can exercise the option? Does it become exercisable in stages?
- ❖ What do you need to do when you exercise the option? Is cashless exercise available? Can you exercise using stock you own?
- ❖ When will the option terminate? Can you exercise after your employment terminates? What if you die while holding the option?

Make sure you keep these documents in a safe place. Be sure to review them from time to time for planning purposes. At a minimum, you want to think about your options before the end of each year to determine whether to exercise some or all of the options by December 31 as part of your tax planning.

Note: *Many companies, including some large corporations, are lax when it comes to option documents. You may be asked to sign an option agreement that says you've received a copy of the plan, even though you've never seen the plan. Insist on receiving a copy of all relevant documents.*

Terminology

Here are some of the important terms used in connection with nonqualified options:

- ❖ You receive the option when the company makes a *grant* or *award*.
- ❖ You *exercise* an option when you take the action specified in the option agreement to buy the stock. Usually you have to fill out a form notifying the company that you are exercising the option and provide cash equal to the purchase price.
- ❖ The *exercise price* (also called the *strike price*) is the amount you have to pay to purchase the stock.
- ❖ The *bargain element* (also called the *spread*) is the difference between the value of the stock and the exercise price. For example, if the value of the stock is \$24 and the exercise price is \$19, the spread is \$5. When the spread is a positive number, the option is *in the money*.
- ❖ Options are *under water* (or *out of the money*) if the exercise price is higher than the value of the stock. There is no particular tax significance to an option being under water, but the practical significance is that the option will not become valuable until the price of the stock recovers.

Typical Terms

Companies have some flexibility in the terms they can offer for incentive stock options. Your option may differ from the typical option in a number of important ways. But it may be helpful to compare your option with the norm:

- ❖ The exercise price is usually set at or near — and can't be below — the value of the stock at the time the option is granted.
- ❖ The option becomes exercisable over a period of several years.
- ❖ Cash payment is usually required at the time of exercise, but some companies make a form of "cashless exercise" available, and others will loan the money needed to exercise the option.
- ❖ The option expires ten years after it was issued, or earlier if employment terminates. You may or may not have an opportunity to exercise options that are already vested (exercisable) at the time employment terminates. Options that are not exercisable at that time typically expire.

Vested ISO grants cannot exceed \$100,000 in any one year

There are limits to the amount of ISOs that can be vested in any one year. The limit doesn't apply to the amount of gain, but rather it applies to the options that vest in any given year. You determine the amount by looking at the fair market value of the stock at the time the option was granted, not at the time the option vests.

For example, assume an executive is granted ISOs for 9,000 shares at \$20 per share (current FMV is \$20). The options vest over 3 years. At the time the options were granted the fair market value of the stock was \$20 per share.

In year 1 the vested value of stock is \$60,000 (3000 shares @\$20 per share) which is below the \$100,000 limitation. If in the next year the executive is granted another 9000 shares at \$25 (the current FMV is \$25), then in year 2 there are two vested option amounts--\$60,000 from year 1 and \$75,000 from year 2 or \$135,000 which exceeds the \$100,000 limit. It makes no difference what spread is made on each option for purposes of the rule; it only refers to the original grant value at the time the option vests. To the extent that the options exceed the \$100,000 limit, they are treated as nonqualified options. (See the White Paper on nonqualified options for more information)

Tax Rules for ISOs

One of the key differences between incentive stock options (ISOs) and nonqualified stock options is that you don't have to report compensation income when you exercise an ISO. But you may have to pay a significant amount of tax anyway, because of the alternative minimum tax (AMT). The description on this page assumes you're using cash (not stock) to exercise your ISO, and that you'll hold the stock for some time, rather than sell it immediately.

Regular Tax Treatment

For purposes of the regular income tax, the exercise of an incentive stock option is a non-event. There is no tax — in fact, nothing to report on your tax return — when you exercise an ISO. This is dramatically different from the treatment of nonqualified options. Generally you report compensation income equal to the difference between the fair market value of the stock and the amount paid under the option when you exercise a nonqualified option.

Because you don't report any income when you exercise an ISO, your basis for the stock you acquired is simply the amount you paid for it. Your holding period begins on the day you acquire the stock: you can't include the period for which you held the option.

Alternative Minimum Tax

So much for the good news. The bad news is that the exercise of an incentive stock option gives rise to an "adjustment" under the alternative minimum tax. The adjustment is precisely the amount you would have reported as compensation income if you exercised a nonqualified option instead of an ISO. In other words, it's equal to the amount by which the fair market value of the stock exceeds the amount you paid for it (otherwise known as the *spread* or the *bargain element*).

The AMT adjustment has three consequences. First and most obviously, you may have to pay AMT in the year you exercise an incentive stock option. There's no way to determine the amount of AMT you'll pay simply by looking at the amount of the bargain element when you exercised your option. The bargain element on your exercise of an ISO may be the event that triggers AMT liability, but the *amount* of liability depends on many other aspects of your individual income tax return. You may find that you can exercise some ISOs without paying any AMT at all. If your bargain element is large, you should expect to pay AMT as large as 28% or more of the bargain element. (The maximum rate for the AMT is 28%, but the tax resulting from a single large item can be greater than that percentage because of the interaction of various features of the alternative minimum tax.)

The second consequence from the AMT adjustment is that some or all of your AMT liability will be eligible for use as a credit in future years without expiration. This credit can only be used in years when you *don't* pay AMT. It's called the AMT credit, but it reduces your regular tax, not your AMT. In the best case, the AMT credit will eventually permit you to recover all of the AMT you paid in the year you exercised your incentive stock option. When that happens, the only effect of the AMT was to make you pay tax *sooner*, not to make you pay *more* tax than you would have paid. But for various reasons you can't count on being able to recover all of the AMT in later years.

The third consequence of the AMT adjustment is very important — and easy to overlook. We noted earlier that the stock you acquire when you exercise an ISO has a basis equal to the amount you paid. But the stock has a different basis for purposes of the alternative minimum tax. The stock's AMT basis is equal to the amount you paid *plus* the amount of the AMT adjustment. That means you'll report a smaller amount of gain for AMT purposes when you sell the stock.

Example: You exercise an ISO, paying \$35 per share when the value is \$62 per share. You report an AMT adjustment of \$27 per share. Later, after satisfying the AMT holding period, you sell the stock for \$80 per share. For purposes of the regular income tax you report gain of \$45 per share (\$80 minus \$35). But for AMT purposes you report gain of only \$18 per share. Your AMT basis is equal to the \$35 you paid plus the \$27 adjustment you reported.

The difference in the amount of gain reported can help you avoid paying AMT on other ISOs you exercise in the same year you sell this stock — or it can help you take advantage of the AMT credit described above. *If you overlook the higher AMT basis of this stock you may end up unnecessarily paying double tax with respect to your ISO.*

The Sale of ISO Stock

You may have to report compensation income if you sell stock you acquired by exercising an ISO before you meet the special holding period requirement for incentive stock options.

Once you satisfy the special holding period (usually one year from exercise date and two years from grant date), you have *mature ISO stock*. A sale or other disposition of this stock isn't a disqualifying disposition. Any profit you have from a sale will be capital gain, *not* compensation. Some people receive an added benefit when they sell ISO stock. Selling this stock may help you claim an AMT credit that will enable you to recover some or all of the alternative minimum tax you paid at the time you exercised the option.

The information contained herein is of a general nature and should not be relied upon without first consulting a financial advisor. If you would like further information please email info@vantagefinancial.com.

VANTAGE FINANCIAL PARTNERS LIMITED
Nine North Vail Avenue, Arlington Heights, IL 60005-1430
(847) 590-9191 Fax (847) 590-9009
www.vantagefinancial.com

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