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The Skinny on Employer Stock Options

A few years ago I received stock options from my then employer. The collapse of Lehman Brothers caused these options to expire worthless. Consequently, not only was I unable to benefit from a potentially lucrative opportunity! I also missed a chance to learn about the tax consequences associated with a profitable option exercise. I have since filled this gap in my financial education. Below is a note that seeks to present, in as clear a manner as possible, the general tax principles that one should be aware of when exercising these options.

There are two types of stock options plans; those that benefit from a potentially favorable tax treatment and those that do not. The first are named **Incentive Stock Option (ISO)** plans and meet the requirement of Section 422 of the Internal Revenue Code (IRC). The others are generically referred to as **Non-Qualified Stock Option (NQS)** plans. To know in which category your stock options fall, consult the plan document that was given to you when the options were granted. If it is an ISO, it should make a reference to IRC 422 on the first or second paragraph of the document. If it does not, the options are most likely offered under a NQSD plan.

ISOs:

In order to benefit from the most favorable tax treatment and receive capital gain rather than ordinary income tax treatment, options exercised under an ISO plan must meet a minimum holding period test that has two components: i) the period between the time of the grant of the options and the sale of the underlying stocks must be at least two years, AND ii) the period between the date of exercise of the options and the date of the sale of the stock must be at least one year. Both tests must be met for the gain on the totality of the transaction to be treated as long-term capital gain and to avoid ordinary income treatment, on all or part of it. When these conditions are met, the sale is considered to be a "qualifying" disposition by the IRS and,

- 1) You do not have to report any W2 income when you exercise the option (although you must report it for Alternative Minimum Tax purpose),
- 2) Any gain resulting from the difference between the exercise price and the market price, upon the sale of the underlying stock, is taxed as long-term capital gain.

This is the best of all outcomes. Under an ISO however, if the minimum holding period tests are not met, the sale is deemed to be a "disqualifying" disposition and is, in whole or in part, subject to ordinary income taxation. Specifically, in a "disqualifying disposition" the positive difference between the exercise price and the market value of the stock at the time of the exercise, called the "bargain element", must be reported as W2 income. For more details on ISOs, a good summary of all the possible permutations and their tax consequences is available at: <https://turbotax.intuit.com/tax-tools/tax-tips/Investments-and-Taxes/Incentive-Stock-Options/INF12049.html>

NQSOs

These are the stock options that are offered under plans that do not meet the various requirements of the IRS for favorable tax treatment and are not subject to the minimum holding period tests mentioned earlier. They are simply ordinary deferred executive compensation.

Just like for any other stock options, there are three dates to consider here for tax purposes: i) the grant date, ii) the exercise date, iii) the disposition date.

- **Grant date:** When the options are offered to you, nothing happens unless the options themselves are quoted and have an “ascertainable value”. If that is the case, that value has to be reported as W2 income at the time of grant. In most instances, there is no ascertainable value and nothing needs to be reported, with no fiscal consequence for the beneficiary.
- **Exercise date:** Upon exercising the option the holder recognizes W2 income for the positive difference between the exercise price and the then market value of the underlying stock. For example, if you have options to buy stock XYZ at \$10 and it is trading at \$30 when you exercise the option, you will recognize \$20 as ordinary income for the year in which the exercise takes place, **irrespective of when the underlying stock is actually sold**. Under a NQSO exercise, this \$20 portion is called the “compensation element”. The compensation element (\$20 in this example) plus the exercise price (\$10) form your new tax basis of \$30.
- **Disposition date:** Using the above example, you will recognize a capital gain upon the sale of the stock if the sale is above the \$30 new tax basis. Depending on how long after the exercise date the stock is sold, the gain will receive either long-term or short-term capital tax treatment. If the sale takes place at a price below \$30, you will recognize a loss.

It is important to remember that, in a NQSO exercise, you end up paying ordinary income taxes on the compensation element portion of the transaction in the year of the exercise, no matter when the underlying stock itself is sold. In the example above, the holder of the option disburses \$10 at the time of the exercise in order to acquire the stock now trading at \$30. In addition, the \$20 positive difference is treated as ordinary income for the year when the exercise takes place and irrespective of when the stock is actually sold. When the beneficiary is caught unaware, unpleasant cash flow issues can ensue.

A good summary of the various tax consequences, under different NQSO scenarios, can be found at: <https://turbotax.intuit.com/tax-tools/tax-tips/Investments-and-Taxes/Non-Qualified-Stock-Options/INF12046.html>

Concluding remarks

This may all feel a little bit convoluted, does it not? In a nutshell, remember the following three key points:

- **First**, ask yourself: Are the options offered under a ISO plan or a NQSO plan?
- **Second**, if under a ISO plan, try to abide by the minimum holding period rules to get the most favorable tax treatment on the whole transaction (capital gain vs. ordinary income),
- **Third**, if under a NQSO plan, remember that you will be subject to ordinary income tax on the compensation element of the transaction when you exercise the option, irrespective of the timing of the sale of the underlying stock.

Finally, because of the many permutations and tax finesses associated with these options, make sure to consult an experienced tax professional to check your math and assumptions before taking action.

I hope you have found these comments helpful. Feel free to contact me with any questions relating to this subject or any other investment or financial planning issue you would like to know more about.

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