

Stock Options

INCENTIVE STOCK OPTIONS

An incentive stock option (ISO) is an option issued to an employee that allows all increases in value to be subject to long-term capital gain treatment if the taxpayer disposes of the option shares more than two years after the date the option is granted and more than one year after the date the option shares are purchased. Also, the employee must continue to be an employee until at least three months before the option is exercised. If these rules are not met, a portion of the gains from ISOs are ordinary income subject to federal tax rates as high as 37 percent.

However, there is a hidden cost to obtaining long-term capital gain treatment from an ISO. The “spread” (the difference between the fair market value of the shares on the purchase date and the option price paid for the shares) must be added into the taxpayer’s AMT calculation for the year the options are exercised. Any AMT attributable to the ISO spread generally is allowed as an AMT credit carryforward to offset regular taxes owed in future years. Thus, any AMT attributable to the ISO is effectively a prepayment of tax, not additional tax.

Planning Suggestion: If you are planning to exercise ISOs before December 31, 2018, that trigger AMT, consider deferring the exercise until early in 2019. Any AMT on such exercise would likely not be due until April 15, 2020, after the required one-year holding period for the stock has been met. At that time the option shares can be sold at long-term capital gains rates, with a portion of the proceeds used to pay the 2019 AMT liability.

Additional Planning: Consider a plan to exercise options each year up to the level that generates AMT. Tax reform increased the amount of preference items you can have before owing AMT tax.

If you have exercised an ISO in 2018 and the value of the stock has decreased, consider a sale before the end of 2018. This action should reduce the AMT effect. The sale must be made to a non-family member (or to an entity not considered to be related to the taxpayer under applicable rules) and the stock cannot be repurchased (even through an exercise of a different option or new compensatory award) for at least 30 days.

NONQUALIFIED STOCK OPTIONS

When a taxpayer exercises a non-qualified stock option (NQSO) that does not have a readily ascertainable fair market value at the time of issuance (generally the case where the option or the option stock is not publicly traded), the spread (the difference between the stock’s fair market value and option price) is taxed as compensation income. When the taxpayer sells the NQSO stock, any subsequent appreciation is taxed as long- or short-term capital gain depending upon the stock’s holding period. Because the spread is taxed as ordinary income, taxpayers in the highest marginal federal tax bracket are taxed at 37 percent.

Planning Suggestion: If a taxpayer expects to be subject to AMT for 2018 and no AMT credit carryforward is expected, the taxpayer should consider increased ordinary taxable income to at least the AMT level by exercising NQSOs. The accelerated ordinary income from the NQSO is effectively taxed at the AMT marginal rate of 28 percent as opposed to 37 percent. In addition, all future appreciation is capital gain. When making this decision, the potential tax savings should be compared with the opportunity cost of accelerating the income taking into account the time value of money