Taxation of Employee Stock Options

Article Highlights:

- Employee Stock Options
- Stock Option Terminology
- Incentive Stock Options
- Non-qualified Stock Options
- Tax Strategies

If you are an employee of a corporation, the company may offer you the option to purchase shares of the corporation at a fixed price at some future date so that you can benefit from your commitment to the success of the company by sharing in the company's growth through the increase in stock value.

There are generally two types of stock options: qualified, also referred to as incentive stock options (ISOs), and non-qualified. The taxation of the two can be quite different.

In case you are not familiar with the terminology used in employee stock option plans, here's a rundown. The option price is the price the company sets as the cost you would pay for a certain number of shares should you decide to purchase the stock (exercise your option); this price will apply even if the stock is trading at a higher value when purchased. The opportunity to exercise the option is often limited to a specific time period in the future. The trading price at the time you purchase the stock is considered the fair market value (FMV) of the stock at the time you purchase it. You may even be granted (awarded) options at different prices and on different exercise dates.

- *Incentive Stock Options* - The big advantage of ISOs is the special tax treatment that permits delayed taxation of the difference between the exercise price and the FMV and allows the employee to benefit from long-term capital gains rates when the shares are ultimately sold. However, for that to happen, the stock must not be sold before 2 years have elapsed between the time the option was granted and the sale of the stock, and the stock must be held for more than one year after exercising the option.

  There is a downside to ISOs. For alternative minimum tax (AMT) purposes, the difference between the exercise price and the FMV of the stock is considered a preference item, and although it is not taxable for regular tax purposes, it is included in AMT income in the year of the exercise. When the difference between the exercise price and the FMV of the stock at exercise is significant, it will trigger the AMT.

  The AMT is generally a punitive method of computing income tax that does not allow some of the tax preferences and deductions that are allowed for the regular tax computation. When an AMT computation results in a higher tax, the higher tax applies. This can sometimes outweigh the benefits of ISOs. However, an AMT credit may be created to reduce the employee's tax in a future year. Unfortunately, using this credit applies only to years when there is an AMT, so its benefit is limited.

- *Non-qualified Options* - For non-qualified options, the difference between the exercise price and the fair market value (FMV) of the stock at the time the option is exercised is treated as ordinary income to the taxpayer in the year of the exercise, and for employees, this amount is generally included as income on their W-2. Even though the income is included on the employee's W-2, the stock sale generally still must be reported on Schedule D and sometimes will result in a loss when the employee has incurred sales costs or the purchase and sale were not simultaneous and have resulted in a gain or loss because of market fluctuations.

Where the option was an ISO, it may be appropriate to avoid the AMT in the year of exercise by selling the stock in the same year. Doing so means the difference between the exercise price and the FMV of the stock will be treated as ordinary income so that the income is the same for regular and AMT purposes; this eliminates the AMT preference for the year. The decision to sell the stock in the year the ISO is exercised or to hold it for long-term capital gain rates requires careful analysis to determine which is the best course of action.

Alternatively, when doing so is beneficial, the taxpayer can exercise an ISO option in small blocks over a period of years, thus avoiding or minimizing the AMT and taking advantage of long-term capital gain rates.

If you have options from your employer and need assistance with the tax ramifications of your particular situation or wish to plan a strategy to excise and sell the stock from options while minimizing the tax, please contact this office.