Incentive Stock Options

This is in response to numerous questions about the federal income tax rules for incentive stock options. It is common knowledge that start-up companies, particularly in high tech fields, hire and retain employees by awarding incentive stock options (ISOs). What is not so well known, however, is the careful tax planning required to minimize taxes and to avoid some tax traps usually unexpected by employees. A particularly stinging tax hazard for employees of rapidly growing companies is the alternative minimum tax that may be imposed on the sale of appreciated employer stock acquired through the exercise of their ISOs. This letter is intended to cover some of the basic rules associated with ISOs.

Regular income taxation of ISOs. There is no income tax imposed when an ISO is granted. In addition, there is no income tax due when the incentive stock option is exercised. The first taxable event is the sale of shares acquired by exercise of an ISO. At that time, the employee recognizes taxable gain equal to the difference between the sale proceeds and the option price (the price the employee paid on exercising the option). If holding period requirements are met, this gain is capital gain. To obtain favorable long-term capital gain tax treatment, stock acquired under an ISO may not be sold before the later of two years from the date of grant of the option, or one year from the date of exercise of the option.

For example: An employer grants an ISO to an employee on March 1, 2006. The employee exercises the option on September 1, 2006 (six months after the grant). The employee should not sell the stock until March 1, 2008, to achieve favorable capital gain tax treatment. March 1, 2008 is at least two years from the date of grant and one year from the date of exercise.

Since the exercise of a statutory option does not result in the recognition of income, it is usually advisable (at least from a tax point of view) to exercise an incentive stock option as early as possible. Early exercise of an option is generally even more important if the stock is appreciating. This will enable the employee to be in a position to sell the stock at the earliest possible date (i.e. two years after the grant) at capital gain tax rates. However, the employee may not want to sell the stock until as late as possible in order to defer taxes. Remember, too, that a stock's appreciation does not guarantee that it will continue to rise - as recent events have demonstrated, stock prices can fall just as rapidly --and just as much or more-- than they rose.

If the ISO holding period requirements are not satisfied, the difference between the fair market value of the stock at the time of exercise and the option price is taxed as compensation. Compensation is taxed as ordinary income, not as capital gain. The ordinary income tax is incurred in the year the stock is sold, which is not necessarily the year the stock is acquired under the ISO.

Since capital gain treatment on the sale of stock acquired under an ISO is crucial, it is important to know certain key dates. Of course, the date of exercise and the date of sale are critical, as is the date the option is granted. The date of grant of the incentive stock option is the date on which the board of directors completes the corporate action constituting an offer of stock under the ISO. The date of the grant is not the date on which the option agreement is prepared.

Alternative minimum tax on exercise of ISO. The more rapidly the underlying stock appreciates, the greater the risk the employee will owe alternative minimum tax (AMT) on the exercise of the option. This is because alternative minimum taxable income (AMTI) is calculated by including the difference between the fair market value of the stock on the date the incentive stock option is exercised and the option price paid (the "ISO spread"). The employee calculates both regular and alternative minimum income tax for the year; the higher of the two will be the amount due.

The employee who incurs AMT may have to pay it from funds other than proceeds of sale of the stock. This could occur if the stock is sold in a tax year later than the year the option is exercised. It could also be necessary if the price of the stock drops and is below its exercise price when it is sold. This risk of phantom AMTI makes tax planning crucial.

Please do not hesitate to call if you need any further explanation of the tax rules surrounding incentive stock options, or if you'd like to discuss more specifically how the rules affect your situation.