

Incentive Stock Options and the Tax Advantage You Might be Missing

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As the New Year begins, we all inevitably start filing taxes. And often we start to think of the many tax advantages missed over the last 12 months. Each year, countless executives and other holders of incentive stock options (ISO's) are guilty of bypassing the small steps when exercising ISOs that can provide significant tax advantages; especially when compared with the tax incurred on alternative, nonqualified stock options (NQ's).

Before exploring the various strategies relating to executive options, it is important to address the differences between NQ's and ISO's.

A Nonqualified Stock Option is taxed upon exercise of the option. The amount of taxes owed is calculated on the difference between the strike price and the market value of the stock and is taxed as ordinary income.

An Incentive Stock Option is taxed when the stock is sold (except when Alternative Minimum Tax [AMT] applies), instead of being taxed at the exercise like an NQ. The tax advantage is incurred when the stock is held for one year from exercise and two years from grant date. At this stage, the holder qualifies for long-term capital gains on the difference between the strike price and the market value of the stock when it is sold. At this stage, it is helpful to see the difference between the two in an example.

Assume you're an executive at Amylin Pharmaceuticals (Nasdaq: AMLN) with 100 NQ's and 100 ISO's. Your strike price is \$10 and the stock is currently trading at \$40. You exercise both on Jan. 2, 2008. When the NQ is exercised, the

spread between the strike price and the stock price (\$30) is taxed as ordinary income. However, when the ISO is exercised, the \$30 spread is subject to AMT if you hold the stock through 2008.

Now, after you exercise the ISO, you hold the stock until Jan. 2, 2009 and sell it when Amylin is trading at \$100. The difference between your strike price and the price of the stock when it is sold (\$90) is taxed as long-term capital gains. If the stock is sold before January 2nd, 2009, it is considered a "disqualifying disposition." That means the lower of the two gains at the time of exercise or sale is taxed as ordinary income. The potential to earn long-term capital gains on the spread is a significant advantage for an ISO versus a NQ.

Following the current theme, it is easy to identify the two major advantages in exercising an ISO early in the calendar year.

In this example, you exercise 100 ISO's late in the year, October 2008, when Amylin is trading at \$50. Your strike price is still \$10. If you hold the stock through Dec. 31, 2008, the \$40 spread is subject to AMT due in April 2009. In June 2009, the sector crashes and the stock falls, trading at \$15. You decide to sell the stock in October 2009 at \$15. You will only be taxed between the strike price and stock price (\$5) at long-term capital gains, while the AMT you already paid in April will now serve as a credit against AMT for future years.

It is worthy to note that during the recent tech bust, technology executives that exercised ISOs late in 2000 paid more AMT than their stock was worth in

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2001. It became a problem for so many executives that Congress recently offered relief. It passed the AMT Credit Fairness and Relief Act of 2007 to help individuals with large AMT credits. As long as the credits have been carried over for at least three years, they allowed you to move some of the surplus to help offset regular income taxes owed. However, it is unknown whether this benefit will be available in the future; one of the reasons it is safest to exercise early in the calendar year.

To carry the Amylin example yet further, assume that instead of exercising in October 2008, you wait until January 2009 to exercise the same ISO's when the stock is trading at \$50 and the strike price is \$10. The sector still crashes in June 2009, but rather than hold the stock through December 2009 – in which you pay the AMT tax on a \$40 spread -- you sell the stock immediately and pay income tax on the \$5 spread.

Finally, it is important for ISO holders to exercise early in the year to avoid a liquidity crunch when taxes are due in April. If ISO's are exercised before April 2007, a holder will have achieved long-term capital gains and be able to sell the stock before April 2008 to supplement tax payments.

While there are significant advantages to ISO's, the strategies can be complicated and destructive if no implemented correctly, so please consult your tax advisor before applying any tax strategies.

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