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What are the important planning considerations and tax implications for stock options?

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Stock compensation can be a highly lucrative form of compensation, but it comes with some risk and complexity. There are important tax implications to consider as well as specific dates to be aware of and monitor, especially for those who receive multiple grants. In this Brief I will discuss the important dates, the similarities and differences between the two main types of stock options, tax planning implications, and the overarching considerations for stock option planning.

The Basics

There are two main types of stock options employees can receive: Incentive Stock Options (ISOs) and Non-qualified Stock Options (NQSOs).

For all stock options, regardless of type, there are 5 important dates to be aware of:

1. <u>Grant Date</u>: The date you are granted stock options, either at the beginning of your tenure with a company or as part of your ongoing compensation.

2. <u>Vest Date</u>: Almost all stock options have a vesting date or schedule. This means the options are not technically yours until a certain amount of time has passed. Once vested, the options become yours and are 'exercisable,' or able to be turned into shares. Note, there is no tax implication when options vest. This time delay is a way for a company to motivate employees to stay.

3. <u>Exercise Date</u>: After your stock options vest, you decide when to exercise those options. When you exercise, you pay the exercise price set in your grant letter to buy the shares. This is a tax trigger, and the event has different implications for ISOs and NQSOs – more on this below. The key point is when you exercise stock options you own the shares.

4. <u>Sell Date</u>: The final date in this sequence is the date you sell those shares. You can do so immediately, but you don't have to.

5. <u>Expiration Date</u>: Stock option grants have an expiration date. You must exercise your options in advance of that date.

Incentive Stock Options (ISOs) vs Non-Qualified Stock Options (NQSOs)

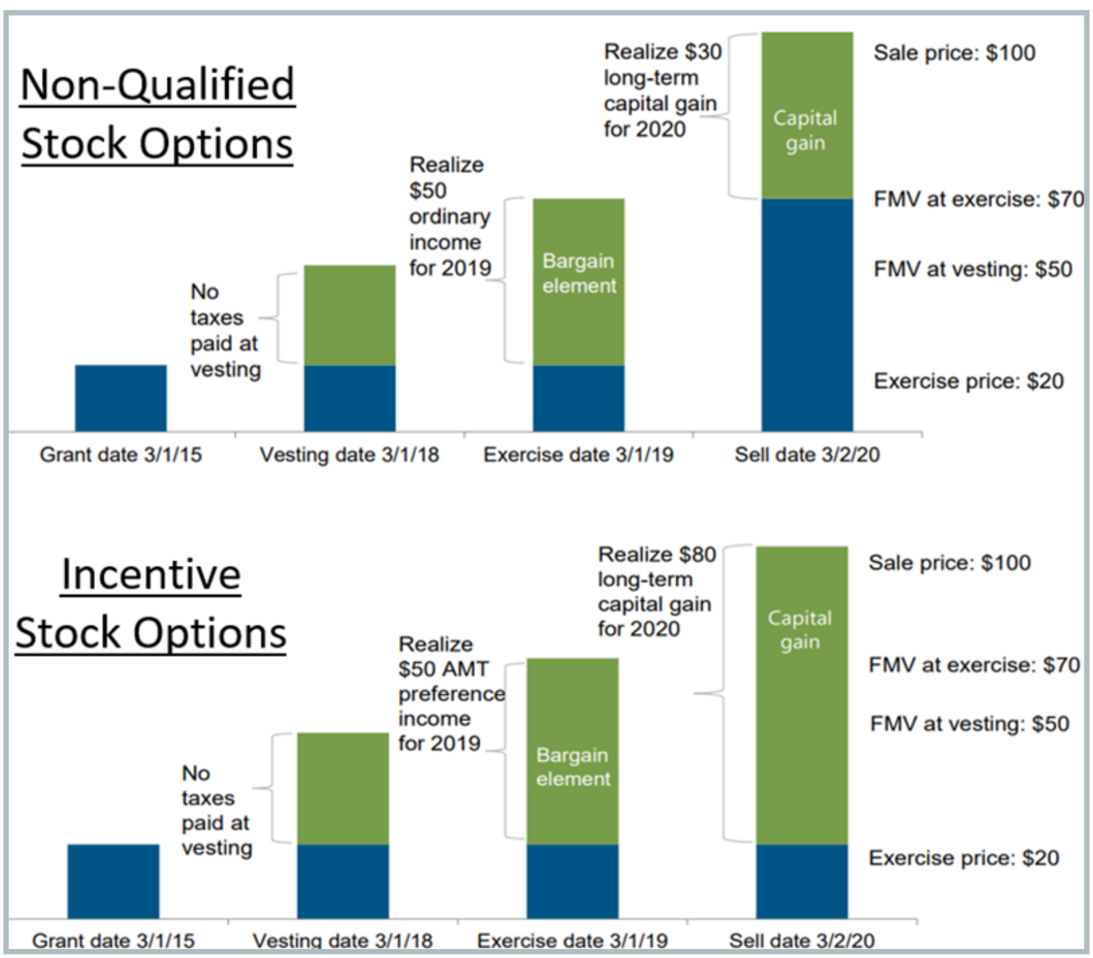
ISOs have a special tax treatment whereas NQSOs have a relatively simple structure.

When you exercise NQSOs, you pay ordinary income tax based on the difference between the exercise price and the current market price (see Figure 1). This tax is paid based on your tax bracket so ***tax planning*** for NQSOs is largely based on understanding where you are within tax bracket ranges, future expectations for your total income, and how much stock concentration you are comfortable with. If you sell your shares immediately after exercising, you pay no capital gains tax.

ISOs have a more nuanced tax treatment. The special treatment, called the ***2&1 rule***, is that you pay long-term capital gains tax instead of ordinary income if you follow a special holding rule. The rule is that you need to have held your options/shares for more than two years from the grant date and one year from exercise date before you sell. Selling after following the holding rule is called a qualifying disposition, and the advantage is that capital gains tax rates are lower than ordinary income tax rates for most people, especially so for high earners. The catch for ISOs is that Alternative Minimum Tax (AMT) may apply when you exercise ISOs. Detailed tax projections and exercise strategies can influence if, and to what degree, you trigger AMT and whether you would receive an AMT credit in future years.

Because of this special treatment and the one-year waiting period requirement after you exercise, the planning implications and tax savings opportunities for ISOs are more robust. Common strategies include year-end or year-beginning moves, income-shifting between years, and the timing of tax deductions, capital gains, and exercises.

Figure 1. Non-Qualified Stock Option vs Incentive Stock Option tax treatment



Stock Option Planning Considerations

Ultimately a stock option strategy is an investment decision with important tax and financial planning implications. There is an inherent cost/benefit to being perfectly tax optimized or holding an overly large single stock position versus speeding up the diversification into other investments.

You may succeed in lowering your tax bill over time or generating higher returns by holding a concentrated position. That said, the risk of a significant drop in the stock price can have a dramatic impact on the value of your holdings and can even reduce your holdings to zero if the stock price falls below your exercise price(s).

More **conservative** strategies will accept a larger tax hit and speed up the pace of diversification, while more **aggressive** strategies may either optimize for taxes, hold a larger concentrated position for potentially greater profits, or both, with commensurately higher risk. These planning considerations are highly situational and vary dramatically based on personal circumstances and company specific factors.

Bottom Line

For all the above reasons, it is generally advisable to consult with a qualified financial planner or tax professional to develop an appropriate plan tailored to your situation, goals, and tax circumstances. Please get in touch if you would like to learn more.

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