

Exercising Stock Options
Tax Consequences and Timing
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Compensatory stock options can make up a substantial component of an executive's compensation and net worth. Therefore, it is prudent to understand tax consequences and timing issues when exercising stock options.

There are generally two types of compensatory stock options: Nonqualified Stock Options ("NQSO") and Incentive Stock Options ("ISO"). Economically, NQSOs and ISOs are very similar, but their tax treatment is different. NQSOs do not meet statutory requirements for certain tax benefits, while ISOs do. This difference means that tax consequences may vary significantly.

Tax Consequences of Exercising Stock Options

Exercising options means purchasing actual shares of the issuer's stock at the price set by the option – the grant price – regardless of the stock's fair market value when exercised. When an employer grants options to an executive, whether for an NQSO or ISO, there are generally no immediate tax consequences to the executive. When he or she exercises NQSOs, the spread – the difference between the stock's fair market value and the exercise price – is taxable as ordinary income and the employer is required to withhold both ordinary income tax and FICA tax. From a practical standpoint, executives typically sell some of the stock they receive from exercising the option immediately to cover the exercise price (strike price) and tax liabilities. Economically, the exercise of a NQSO and immediate sale of the stock is virtually the same as if the executive had received a cash bonus in an amount equal to the spread.

Because ISOs are granted special tax treatment, no regular taxable income is generated upon the exercise of an ISO. Though this appears to be a huge benefit of an ISO when compared to an NQSO, the exercise of an ISO requires the shares to be held for at least one year from the

exercise date and could result in Alternative Minimum Tax (“AMT”). While a thorough study of the AMT is beyond the scope of this article, it should be noted that executives must add the spread amount to their alternative minimum taxable income. If this AMT adjustment results in the executive paying AMT, the AMT attributable to the option exercise is eligible to be credited in subsequent years when regular tax exceeds AMT.

When selling shares after the required one-year holding period, the subsequent sale of the stock results in a capital gains tax (rather than ordinary income tax) on the excess of the stock’s sale price over the grant price. Any AMT adjustment – when recognized upon exercise – reverses as a negative AMT adjustment when the stock is sold. If the stock has not declined in value, this will usually result in the triggering of any remaining AMT credit created upon the ISO exercise.

If the executive disposes of the stock within the twelve month holding period, the shares are subject to a “disqualifying disposition,” resulting in tax consequences that are essentially the same as the NQSO described above.

Timing Considerations for Exercising Stock Options

There are numerous factors that affect the timing of exercising stock options to maximize profit. While an option is not actual stock, but rather a right to acquire stock, the option may have significant value and should be managed as a component of the executive’s entire investment portfolio.

Sound investment principles should be adhered to when managing stock options. If, for example, the issuer’s stock price fluctuates significantly (or is volatile), it is generally a good idea for the executive to exercise options in a systematic manner to take advantage of dollar cost averaging.

The executive should also take into account the relevant diversification of his or her entire investment portfolio – including the options. In cases where the issuer’s stock performance has done very well, the executive’s investment portfolio may be over-weighted (because of the

options) in the issuer's stock. A disciplined exercise and sell program will help mitigate some of the investment risks associated with a volatile stock price and lead to a total portfolio that is better diversified.

Window limitations and option expiration dates are other aspects to be considered. Window limitations mean that stock options can only be exercised during a period in which there are no expected company announcements that affect the value of the stock, such as earning reports, mergers or acquisitions, and new product or technology introductions. To state the obvious, once options expire, they have no value. Also, knowing when options expire is critical to executing an exercise strategy that will increase the value of the stocks when sold.

Tax considerations are also a significant factor that affects the timing of exercising options. When exercising NQSOs, for example, it is important to ensure that the state tax withheld on the exercise is sufficient to cover the actual state tax liability owed on that income. If not, additional state tax should be paid in the year of the option exercise. Otherwise, there could be a significant AMT consequence. Furthermore, any AMT situation that arises because of the payment of state tax is not eligible for the AMT credit addressed earlier, resulting in a permanent additional tax that could have been avoided with proper planning.

ISO timing considerations are even more pronounced because of both possible AMT consequences and the requirement to hold the stock for one year to receive capital gain treatment upon the ultimate sale. All other factors being equal, it may be best to exercise ISOs during the first three and a half months of the year. This enables the executive to exercise the ISO, hold the corresponding stock for at least twelve months, and be in a position to sell the stock at capital gain rates before filing his or her tax return on April 15th of the following year.

Proactive tax and investment planning helps executives minimize both income taxes and investment risk while maximizing wealth.

