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Private Wealth Management

Tax Consequences of Stock Options

There are two main types of stock options: Nonqualified Stock and Incenctive Stock Options. The subsequent tax treatment will vary, as well.

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THE DIFFERENCE BETWEEN INCENTIVE AND NONQUALIFIED STOCK OPTIONS

There are two types of stock options that are typically granted – Incentive Stock Options (ISOs) and Nonqualified Stock Options (NSOs). The tax treatment of these two options is significantly different.

NONQUALIFIED STOCK OPTIONS

NSOs result in ordinary income immediately upon exercise. The difference between the stock's current market value and the exercise price is taxed at the ordinary tax rates, not as a capital gain, whether the stock is immediately sold or held. NSOs may be granted to employees, consultants, directors and other persons associated with the company, and allow the optionees to achieve simple diversification.

INCENTIVE STOCK OPTIONS

ISOs ("qualified" or "statutory") meet the requirements of Section 422(b) of the Internal Revenue Code and therefore qualify for preferential tax treatment. Upon exercise of an ISO, the spread between market value and exercise price is considered income for Alternative Minimum Tax (AMT) purposes only. With proper planning, an optionee may be able to avoid income tax entirely at exercise, unlike with an NSO. If the stock is then held for more than one year after exercise and two years after grant date, any appreciation beyond the exercise price is taxed as a capital gain. Because capital gain rates are lower than ordinary tax rates, this can lead to a significant savings over an NSO. If the stock is sold within a year of the exercise, the spread at the exercise will be taxed at ordinary income tax rates, and any appreciation subsequent to the exercise will be taxed as a short-term capital gain.

TAX IMPLICATIONS FOR INCENTIVE STOCK OPTIONS

Upon grant:

- No tax impact.

Upon exercise:

- No regular tax impact. Regular tax basis in shares is the cash paid to exercise.
- Federal AMT preference equals difference between exercise price and fair market value (FMV) at exercise, reported on Form 6251, line 2i. AMT basis in shares is exercise price plus AMT preference (i.e. FMV).

SALE OF SHARES ACQUIRED THROUGH AN ISO EXERCISE:

- Regular tax – capital gain reported on Schedule D.
- Federal AMT – Calculate gain based on AMT basis, then report difference between AMT gain and regular tax gain on Form 6251, line 2k

DISQUALIFYING DISPOSITION:

- If shares acquired through ISO exercise are sold within two years of grant or one year of exercise, the spread between exercise price and FMV is ordinary income and reported on W-2.
- If exercise and sale are in different years, the optionee doesn't have to amend the prior year return or W-2, but should report correct amounts on current year W-2 and return.
- Income recognized on W-2 is NOT subject to income tax withholding or FICA or Medicare withholding.

TAX IMPLICATIONS OF NONQUALIFIED STOCK OPTIONS

Upon grant:

- No tax impact upon grant, if granted at FMV.

Upon exercise:

- The spread between exercise price and FMV of options is ordinary income, reported on the employee's W-2 and is subject to withholding.
- Basis in shares is exercise price plus amount recognized as ordinary income (i.e. FMV).
- No special treatment for AMT purposes.
- Minimum withholding is 25% for Federal, 1.45% for Medicare, and 6.2% for FICA (if not over cap), plus applicable state tax withholding.
- If shares are sold immediately, tax withholding can be taken from sales proceeds.
- If shares are not sold, employee must deliver a check to payroll department for tax withholding amounts.

SALE OF SHARES ACQUIRED THROUGH AN NSO EXERCISE:

- Gain is generally reported on Schedule D similar to any other stock transaction. Usually a 1099-B is issued showing proceeds from sale net of any brokerage fees. This is the amount to show on Schedule D.
- Basis in shares is exercise price plus income in W-2.
- If brokerage fees are paid on the sale, they should either be netted against the proceeds on the 1099-B or against the imputed income on the W-2 (for immediate exercise and sale). If fees are paid and neither is done, adjust (increase) the basis for this amount. Do not adjust the proceeds, which should always match the 1099-B.

PLEASE NOTE: Because state taxation policy varies from state to state, state taxes are not discussed in this article. Please consult your tax advisor for specific state tax regulations.