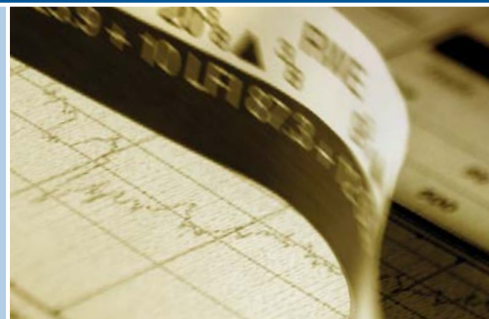


# Strategies for Exercising Incentive Stock Options

## Topical Education for Today's Investor

## STOCK OPTIONS

Equity compensation comes in many forms — outright stock grants, employee stock purchase plans, and stock options. Of these, incentive stock options (ISOs) provide the most unique challenge from a tax planning standpoint.



### Stock Options Defined

Stock options are a popular form of employee compensation, most often issued to executives. Under such agreements, individuals are given the right to buy shares of their company's stock for a predetermined period of time at a price equal to the market price at the time the options were granted. Note that the exercise price may be less than fair market value at the date of grant if the grant is pursuant to an employee stock purchase plan. The window of time that the holder has to exercise an option will vary depending on the details of a particular agreement — but if it is not exercised within the specified time, the option will expire. Stock options can provide an added incentive for executives to maximize company profit and increase share prices.

It is important to note that there are two types of stock options, nonqualified and incentive stock options. Nonqualified stock options are by far the most common type issued to employees, while incentive stock options are reserved primarily for executives. The key differences between the two types of options are most apparent in the ways in which they are taxed.

### Taxing Consequences: Nonqualified vs. Incentive Stock Options

In general, nonqualified stock options are taxed more quickly and at higher rates than incentive stock options. Holders of nonqualified stock options must report income on any paper profit they earn when they “exercise” the option to buy the stock — even if they do not sell the stock immediately. And since the profit is treated as compensation, it is taxed at ordinary income tax rates instead of the preferred, lower capital gains tax rate. With incentive stock options, no taxes are due until the holder actually sells the shares purchased with the option. And if the stock is held long enough to satisfy a special holding period, any gain from the sale of stock will be taxed as a long-term capital gain.

### ISOs and the Alternative Minimum Tax (AMT)

Although incentive stock options trigger no regular income tax, they do present another potential tax hurdle: the alternative minimum tax (AMT). The AMT is a parallel tax system developed by the IRS to ensure that high-income individuals pay their fair share of taxes regardless of deductions, credits, or exemptions. In the case of ISOs, AMT comes into play in the year in which you exercise an option and

buy shares. AMT liability is triggered when the fair market value of the stock, when exercised, exceeds the preset exercise price — otherwise known as the spread. The actual amount of your AMT liability depends on many other elements reported on your annual income tax return. It's also possible that you can exercise a stock option and owe no AMT.

It should be noted that although the Jobs and Growth Tax Relief Reconciliation Act of 2003 tinkered slightly with the AMT exemption amounts, it did not meaningfully affect the way most individuals choose to manage their stock options.

### ISOs: What to Expect<sup>1</sup>

Before a company issues incentive stock options, it must first have a stock option plan, which establishes guidelines for granting and governing options. In addition, employees who are granted options should receive an option agreement detailing the terms of the contract. While companies have some flexibility in structuring option agreements, it may be helpful to understand what the “typical” agreement entails.

- The exercise price is usually set at or near — and can't be below — the value of the stock at the time the option is granted.
- The option becomes “vested,” or exercisable over a period of several years.
- Cash payment is usually required at the time of exercise, but some companies make a “cashless exercise” available; others will loan the money needed to exercise the option.
- The option expires 5 to 10 years after it was issued — earlier if employment terminates. You may or may not have an opportunity to exercise options that are already vested (exercisable) at the time employment terminates. Options that are not exercisable when employment terminates, typically expire.

### Exercising Your Options

The tax implications of compensatory stock options can be confusing, even to seasoned financial professionals. This is particularly true for incentive stock options and their potential exposure to AMT liability. If, as an ISO holder, your primary goal is to minimize or avoid exposure to the AMT, you may want to consider some of the following strategies.

- **Exercise early** — If you feel confident that your company stock will increase in value over time, you may want to exercise your options sooner rather than later, before you realize too much of a paper profit. Since AMT exposure increases as the spread between the current market price and the preset exercise price increases, exercising sooner may reduce your chance of owing AMT.
- **Exercise shares gradually** — By exercising just a portion of your shares each year, you can reduce your chance of triggering the AMT while also starting the clock on the holding period required to generate profits at the more favorable long-term capital gains rates instead of ordinary income tax rates. (Income tax rates generally apply if you sell within 12 months of exercising your option.)
- **Make a “disqualifying disposition”** — By selling ISO shares in the same year they were exercised, an option holder makes what is referred to as a disqualifying disposition. This action allows you to avoid the AMT completely, but it also means that you'll owe tax on your profits at ordinary income tax rates. This strategy may make most sense in a market where stock prices are trending downward.

- **Hold tight for the long term** — Instead of exercising options when the underlying stock appreciates, hold on to their future potential and invest the assets you would have used to exercise the options to further diversify your equity portfolio (and reduce your risk potential). No exercise means no AMT exposure — and if all goes well, you can use proceeds from your alternative equity investment to exercise your ISOs at a later date. In addition, the longer you hold on to your options, the better the chance that Washington lawmakers may amend the AMT regulations in your favor.
- **Manage other sources of AMT exposure** — If the spread on your exercised options is significant, find ways to reduce other sources of income that contribute to the AMT problem. For instance, defer bonus or other cash compensation, and use capital losses realized in other investments to offset capital gains. Finally, make sure you consult a trusted tax advisor to help decide if you are taking advantage of the AMT exemption.

### Seek Professional Guidance

Managing the tax implications of incentive stock options is a complicated undertaking. That's why, if you hold an ISO, it is wise to obtain prompt professional advice. A tax and/or financial advisor can help you review your personal situation and determine the best strategy for managing this potentially powerful investment.

**For more information, please consult with your financial advisor.**

### Points to Remember

1. A popular form of employee compensation, stock options offer individuals the right to buy shares of their company's stock for a predetermined period of time at a price generally equal to the market price at the time the options were granted.
2. Generally, there are two types of stock options: nonqualified stock options (NQSOs) and incentive stock options (ISOs). Each has different tax ramifications. NQSOs are taxed more quickly and at higher rates than incentive stock options. Although incentive stock options trigger no regular income tax, they do present another potential tax hurdle: the alternative minimum tax (AMT).
3. The AMT is a parallel tax system developed by the IRS to ensure that high-income individuals pay their fair share of taxes regardless of deductions, credits, or exemptions. In the case of ISOs, AMT liability is triggered when the fair market value of the stock, when exercised, exceeds the preset exercise price.
4. Although the Jobs and Growth Tax Relief Reconciliation Act of 2003 tinkered slightly with the AMT exemption amounts, it did not meaningfully affect the way most individuals choose to manage their stock options.
5. There are several strategies ISO holders may consider to help minimize or avoid exposure to the AMT, including exercising shares early, exercising shares gradually, making a "disqualifying disposition," meeting holding requirements, and taking advantage of AMT exemptions.
6. Managing the tax implications of ISOs is a complicated undertaking and may require professional advice.

### Important Additional Notes

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<sup>1</sup> Source: Adapted from "Incentive Stock Options" at [www.fairmark.com](http://www.fairmark.com), an affiliate of Fairmark Press.

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