INCENTIVE STOCK OPTIONS

Should You Consider Exercising ISOs Now?

By: **Daniel Park**, Partner | New York

Cheryl Donaldson, Principal | New York

While tech stocks have had a challenging start to 2022, this environment could present an opportunity for you to take advantage of their incentive equity. There are countless articles on the rules for the qualification, advantages, risks, and tax implications of incentive stock options, but one important consideration is when to exercise. Below we explore why now could present the right opportunity.

TAX TREATMENT FOR INCENTIVE STOCK OPTIONS (ISOS)

ISOs offer tax advantages that non-qualified stock options (NSOs) do not. Unlike NSOs, when ISOs are exercised, the spread between the exercise price and fair market value is not included in compensation nor subject to ordinary income and FICA taxes. Essentially, the "benefit of the bargain" is treated as tax-free compensation. When those ISO shares are subsequently sold, the spread between exercise price and fair market value at sale is taxed as a capital gain or treated as a capital loss. However, ISOs must meet two conditions to qualify for more favorable long term capital gains tax treatment at sale and to avoid ordinary income taxation:

a. The exercised shares must held for more than one year from the date of exercise, and

b. Held for more than two years from the date of the grant.

If the above holding requirements are met, then the sale of the previously exercised ISOs is called a "qualifying disposition," which may trigger significant tax savings. For example, consider the following simple scenario comparing the tax consequences of exercising an ISO versus a NSO [Exhibit 1].

Exhibit 1: Taxpayer is in the 37% tax bracket, and is granted 1 ISO share and 1 NSO share at $1 on January 1, 2020. On January 1, 2021, Taxpayer exercises and holds the ISO and the NSO when the fair market value is $11. On January 2, 2022, Taxpayer sells the shares for $21, resulting in an ISO qualifying disposition and an ordinary sale for the NSO. The results are illustrated as follows:

	ISO GRANT	NSO GRANT
# OF OPTIONS GRANTED	1	1
EXERCISE PRICE	$ 1.00	$ 1.00
FMV AT EXERCISE	$ 11.00	$ 11.00
BARGAIN ELEMENT	$ 10.00	$ 10.00
TAXABLE COMPENSATION	$ 0.00	$ 10.00
TAX @ 37%	**$ 0.00**	**$ 3.70**
BASIS IN STOCK	$ 1.00	$ 11.00
FMV AT SALE	$ 21.00	$ 21.00
GAIN	$ 20.00	$ 10.00
LT CAPITAL GAIN TAX @ 20%**	**$ 4.00**	**$ 2.00**
TOTAL TAX PAID	**$ 4.00**	**$ 5.70**

TAX SAVINGS WITH ISO	$ 1.70
TAX SAVINGS % WITH ISO	29.82%

* Does not consider FICA taxes and potential additional Medicare tax
** Does not consider potential net investment income tax at 3.8%

THE "DREADED AMT"

There is a potential downside, however. For ISOs, the difference between the exercise price and fair market value at exercise may be subject to the Alternative Minimum Tax (AMT). The $10 spread from our above example must be included in the AMT calculation and may result in additional tax. The greater the spread between exercise price and fair market value, the greater the AMT exposure. Briefly, the AMT is a parallel tax calculation that compares the tax computed using regular tax brackets versus a flat tax of 26% or 28% (depending on the net AMT taxable income) when certain items of income and deductions are added back to federal adjusted gross income. If the AMT result is higher, then the difference between the regular tax and AMT amount is called the "alternative minimum tax" and is payable with the filing of the tax return.

If exercised ISOs create an AMT liability, then the prorated amount of additional tax will generate a credit (AMT credit) that may be credited against tax liability in future years when regular tax exceeds the AMT. In addition, ISOs carry a separate AMT tax basis that is equal to the fair market value at exercise. Therefore, if ISOs are subsequently sold at a gain, then the AMT calculation will include a negative adjustment equal to the difference between the regular tax basis (amount paid for the shares) and the AMT basis (fair market value at exercise). In some cases, this means that the "gap" between regular tax and AMT can widen, thus allowing for additional AMT credits to be released and used to reduce regular tax liability.

Returning to our above example, assume that the ISO exercise generates AMT. At the 28% AMT rate, the $10 bargain element would result in $2.80 of tax in 2020 and an AMT credit would be generated for future use. Further, the "AMT basis" for that share is increased to $11 ($1 exercise price plus $10 bargain element subject to AMT). Thus, in 2022, the regular tax gain would be $20, while the AMT gain would be only $10, resulting a $10 negative adjustment for AMT calculation purposes.

IS THE OPPORTUNITY NOW?

Many executives and other employees of tech companies received ISO grants when those companies' stock prices were extremely low, and in some situations, pre-IPO. When tech stocks skyrocketed and/or went public, and the spread between the exercise price and fair market value increased, it was not uncommon for an unsuspecting taxpayer to exercise their ISOs and end up with a surprise tax hit thanks to the AMT. With proper planning, the exposure could have been limited or eliminated by leveraging with other income. Recall that NSOs and RSUs are considered ordinary income when exercised or vested. That additional ordinary income creates a larger spread between the ordinary income tax and AMT, thus decreasing AMT exposure. As AMT exposure decreases, there is more room to exercise ISOs without triggering AMT. Therefore, strong stock performance could provide an opportunity, but what about a down market?

So far this year we have seen a plunge in the value and price of tech stocks. Could these current valuations provide an opportunity to exercise ISOs at these lower valuations and thus limit AMT tax exposure? When ISOs are exercised, the taxpayer pays out-of-pocket for the shares. Typically, that cost is low because the options were offered early in the life of a start-up or new company. Depressed stock prices decrease the spread between the exercise price and fair market value and could therefore present an opportunity to exercise more ISOs, and possibly avoid AMT.

Following is a basic example [Exhibit 2] that does not include other income, investment income, deductions, or other credits and ignores the marginal tax rate system. It is not a true tax calculation but merely an example to express how the AMT works.

Exhibit 2: Assume Taxpayer earns $2,500,000 in base salary and bonus and their highest marginal tax rate is 37%. Using an AMT tax rate of 28% and some basic worksheet skills, one can roughly calculate that Taxpayer's situation may allow for $800,000 of additional AMT income without triggering any AMT liability.

SIMPLE AMT COMPARISON	ORDINARY		AMT	
BASE/BONUS/RSU	$	2,500,000.00	$	2,500,000.00
NQ INCOME	$	-	$	-
ISO INCOME		N/A	$	803,571.43
DQ DISPOSITION	$	-	$	-
TOTAL	$	**2,500,000.00**	$	**3,303,571.43**
TAX RATE		**37%**		**28%**
FED TAX	$	**925,000.00**	$	**925,000.00**
		DIFFERENCE	**$**	**-**

Without considering other AMT taxable income, the illustrated $803,571.43 of ISO/AMT income represents the amount of spread between grant price and fair market value that can be realized by exercising ISO's without triggering an AMT liability. As the company's stock price dips, more ISOs may be exercised to make up this $800K. Thus, with proper planning, a taxpayer may be able to exercise large tranches of ISOs without incurring a large tax bill due to AMT exposure.

There is also an argument that triggering AMT is not the end of the world. This can be true if advisors are creating a strategy to maximize future AMT credits, which makes sense in certain situations. On the other hand, future tax law changes could make utilizing credits more challenging. For example, prior to the Tax Cuts and Jobs Act (TCJA), the unlimited state and local tax deduction was added back to the AMT calculation and caused many middle income range taxpayers to land in the AMT. Though the AMT was originally not designed to capture those taxpayers, Congress did not act to change the AMT thresholds to align more appropriately with the income levels that the tax was originally meant to target. The future of tax legislation is currently uncertain; however, we do know that the TCJA is currently set to sunset at the end of 2025. If that occurs without Congressional action, and if the state and local tax deduction cap is lifted, then it will become increasingly more difficult for taxpayers in high tax states to avoid the AMT and therefore, to benefit from the AMT credit in later years.

PROPER PLANNING IS CRITICAL

There are many factors to consider when exercising options. The common consensus is that it is extremely difficult to perfectly align leverage risk, timing risk, and tax consequences. Some planners will advise against attempting to time ISO exercises. However, as discussed above, it is possible to limit one's risk exposure to the amount invested (i.e., ISO exercise price) and to take advantage of the opportunity to reduce tax exposure in today's market environment. Current conditions may provide ideal opportunities; however, each taxpayer's situation is unique and there is no one-size-fits-all solution. The answer involves careful planning and complex tax calculations. That is where an experienced advisor who is knowledgeable in employee benefits and tax, is extremely important.

ABOUT THE AUTHORS

DANIEL PARK
Partner | New York

Dan is a Partner in the New York office and has more than twenty years of experience counseling corporate executives and high net worth individuals and families in tax, investments, insurance, company benefits, estate planning, and retirement planning. He leads the firm's Executive Financial Counseling practice and is a member of the Personnel Development Committee.

Prior to joining Cerity Partners, Dan was President of Dendron Advisors, LLC, an investment advisory firm. Prior to Dendron, Dan was Vice President at Black Coral Financial Advisors and Senior Executive Financial Planner at the Ayco Company, A Goldman Sachs Company.

He earned a Bachelor of Science in marketing from Rutgers College of Business in 2001. In 2007, he became a CFP® professional, receiving the designation from the College for Financial Planning in Denver, CO. Daniel is a Registered Insurance agent.

CHERYL DONALDSON
Principal | New York

Cheryl is a Principal and a member of the firm's Executive Financial Counseling team. With over 20 years of extensive tax and legal experience, she provides comprehensive tax analysis, planning, and guidance as part of the overall financial plan for corporate executives and high net worth individuals.

Prior to joining the Cerity Partners team, Cheryl worked as an independent consultant/quality control reviewer. Her clients included law firms, CPA firms, and a boutique financial planning firm serving creative artists. In addition, she provided tax services to her own individual clients. Before moving to Florida, Cheryl was a Staff Attorney in the Parsippany, NJ office at The Ayco Company, a Goldman Sachs company and she subsequently worked there remotely and seasonally as a tax reviewer for many years. Before working at The Ayco Company, Cheryl worked at Andora & Romano in Paramus, NJ as an elder law attorney.

Cheryl earned her Bachelor of Arts degree from Tufts University and her law degree from New York Law School. She is admitted to the Florida, New York, and New Jersey bars, and is an Enrolled Agent with the IRS.