

Tax Treatment of Incentive Stock Options

Topic: How the IRS taxes Incentive Stock Option (ISO) Distributions
Author: Terry L. Kaul, CFP
Sponsor: Vantage Financial Partners Limited
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Executive Summary: A brief summary of the tax characteristics of incentive stock options.

Incentive Stock Options offer the holder the opportunity to have increases above the strike price taxed at long term capital gain rates rather than income tax rates. Several restrictions apply.

Grant of Incentive Stock Options

Receiving an ISO grant is not a taxable event. No tax or filing requirements occur when options first become eligible for exercise.

Exercising Incentive Stock Options

If you ISO's were exercised last year, and if the taxpayer is not subject to the alternative minimum tax (see below), then the exercise will not affect tax or reporting requirements. There was some uncertainty if certain stock options were subject to social security taxes upon exercise. The Jobs Creation Tax Act of 2004 Bill clarifies that income realized in the exercise of incentive stock options (ISO's) is exempt from such taxes. This applies to all stock acquired after the date of enactment.

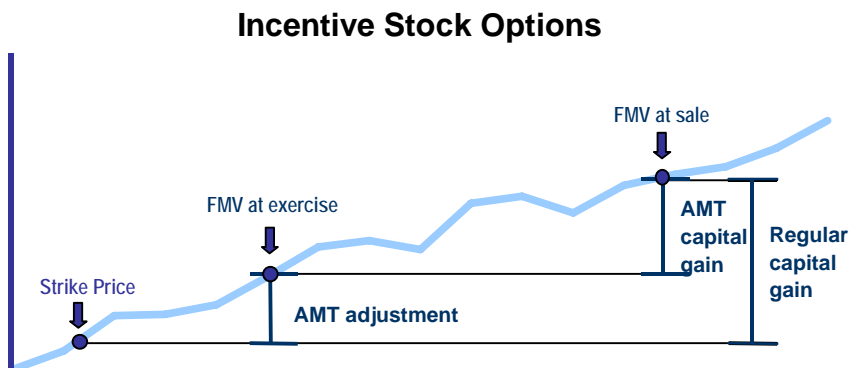
Qualifying Disposition of ISO Stock

The regular tax considerations on a sale or other disposition (i.e., gift, transfer) of ISO stock are based on whether the taxpayer made a qualifying or disqualifying disposition of ISO stock. If the ISO shares that were sold had been held for at least one year after the exercise date and two years after the grant date, then the transaction is reported as a long term capital gain or loss. The gain or loss is based on the difference between the sales price and the exercise price.

Disqualifying Disposition of ISO Stock

A disqualifying disposition occurs when the ISO shares are sold before the special holding period. If the disqualifying disposition was a sale to an unrelated person, it is treated as follows:

- ❖ If they were sold for less than the taxpayer paid for them, report a capital loss.
- ❖ If the shares were sold for more than the taxpayer's original price but less than



the shares were worth at the time they were exercised, the entire gain is compensation income, which should be included in the taxpayer's Form W-2. The transaction should also be reported on Schedule D, but the basis will be equal to the selling price.

- ❖ If the shares were sold for more than the taxpayer's original price and more than the shares were worth at the time they were exercised, report compensation income equal to the difference between the value of the shares and the amount paid at the exercise date. Additional gain is reported as capital gain.

Alternative Minimum Tax (AMT) Issues at Exercise

The exercise of Incentive Stock Options frequently causes the taxpayer to pay Alternative Minimum Tax (AMT). Taxpayers who exercise and then hold the ISO shares for the balance of the year, you will have an "AMT adjustment" equal to the amount by which the fair market value of the stock at the time of exercise exceeded the amount you paid for the stock.

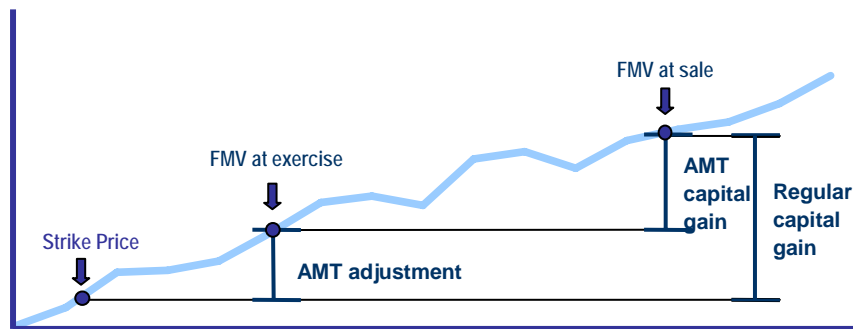
- ❖ Effect Of AMT Adjustment In Year Of Exercise -- Having an AMT adjustment may trigger an AMT liability, but there is no way to know until accountant completes Form 6251 and calculate the adjustment. If you are subject to the alternative minimum tax, you may have to pay a tax of 26%, 28%, or more of the amount of the adjustment.
- ❖ Certain ISO plans allow immediate exercise of ISOs with the receipt of non-vested shares. If you made an 83(b) election for AMT purposes within 30 days of exercise of those options, you should include the spread at exercise as an AMT adjustment and attach a copy of the election to your tax return.

Sale Of ISO Stock -- If last year you made a qualifying disposition of ISO shares, the basis of the shares will be calculated differently for regular tax and AMT purposes. Since the stock's AMT basis will be equal to the amount you paid plus the amount of the original AMT adjustment, you will report a smaller AMT gain. The difference between the gain reported for regular tax purposes and the AMT gain will result in a "negative adjustment" for AMT purposes, which should be shown on line 9 of Form 6251.

This adjustment can reduce the AMT you would otherwise pay on your tax return. One point to note, though: The negative adjustment can't be greater than the capital gain you reported for regular tax purposes plus \$3,000 (\$1,500 if married filing separately). That's because the \$3,000 capital loss limit applies for AMT purposes. You should also keep in mind that if you use Part III of Form 6251 when you calculate your AMT tax liability (i.e., you have net long-term capital gain for AMT purposes and are subject to the maximum rate of 8%, 10%, or 20%), you should reflect the negative adjustment in that calculation.

If, however, you made a disqualifying disposition of ISO shares last year, your AMT reporting requirements will vary depending on the year you exercised your options. If both the disposition and exercise occurred last year, there is generally no AMT reporting obligation. If you made a disqualifying disposition last year but exercised your options in a prior year, you will have a negative adjustment for AMT purposes as a result of the disposition.

Incentive Stock Options



Special Issues

Effect Of Wash Sale Rules On Disqualifying Dispositions -- As discussed above, if you made a disqualifying disposition in the same year of your option exercise, you avoid AMT reporting, although you remain subject to the regular tax rules affecting disqualifying dispositions of ISO shares. Those rules generally require that you report ordinary income equal to the actual profit on your sale.

Market conditions last year led some financial advisors to suggest that clients who made sales should repurchase the shares. Hopefully, this was not your situation, as you could have a wash sale problem. Taxpayers who repurchased shares (or exercised another option) within 30 days of the disqualifying disposition must report compensation income equal to the original option spread rather than the amount of actual profit.

AMT Credit -- If you do not have AMT liability for last year but were subject to the tax in a prior year, don't forget to check if you can use any of your AMT credit to reduce your regular tax liability. The credit is allowed to the extent that your regular tax exceeds your tentative AMT liability. To claim the credit, file Form 8801 with your return. If you do have AMT liability for last year, file Form 8801 to calculate the credit, which might be available for carryover to future years.

The information contained herein is of a general nature and should not be relied upon without first consulting a financial advisor. If you would like further information please email info@vantagefinancial.com.

VANTAGE FINANCIAL PARTNERS LIMITED
Nine North Vail Avenue, Arlington Heights, IL 60005-1430
(847) 590-9191 Fax (847) 590-9009
www.vantagefinancial.com

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