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Mr. A Smith
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Dear Mr. Smith:

TAX CONSEQUENSES OF INCENTIVE STOCK OPTIONS

Does your company have an incentive stock option (ISO) plan? If so, have you ever thought about the tax consequences to you of your company's offer to grant you an ISO on its stock. The ISO gives you the right to buy 1,000 shares of the company's stock at its fair market value (FMV) at the time of the ISO's grant, which is expected to be about $100 per share, for a five-year period following the grant (it could be a 10-year period if you owned less than 10% of the company's stock).

The grant of the ISO to you will not be taxable. Nor will your later exercise of the ISO—except, as discussed below, that it may make you subject to the alternative minimum tax (AMT). For example, if the market value of the stock goes to $150 per share and you exercise the option and buy the 1,000 shares with a market value of $150,000 for the $100,000 option price, you won't be subject to regular income tax on your $50,000 bargain purchase.

By Jan. 31 following the close of the year in which you exercise an ISO, your employer is required to provide you with a written or, if you consent, an electronic statement containing information about the stock that you received when you exercised your ISO. This information will include the date that the ISO was granted, the date when the stock was transferred to you, the number of shares that were transferred, and the stock's FMV at the time the ISO was exercised. From this information, we will be able to determine how long you need to hold the stock to qualify for favorable long-term capital gain rates on the difference between the price you paid for the stock and the amount you realize on its sale (see below) or, if you do not hold the stock long enough for this favorable tax treatment, how much additional compensation income will be attributed to you from the ISO exercise.

If you later sell the stock, say when its value reaches $200 per share, for $200,000, then your $100,000 profit will be taxed as a capital gain in the year of sale. Although the sale is taxable, no income tax will be withheld from your paycheck.

If you want to qualify for the favorable tax treatment available with an ISO (so the $100,000 employment-related profit is taxed at capital gain rates, rather than at the higher ordinary income tax rates imposed on regular compensation), then you cannot make a “disposition” of the stock: (1) within two years after the ISO is granted; or (2) within one year after the stock has been transferred to you. A “disposition” includes a sale, exchange, gift, or similar lifetime transfer of legal title.

If you dispose of the stock before both of the required holding periods have expired, then you will be taxed as if you had received compensation in the year of disposition. You will have to treat the gain on that premature disposition as ordinary income to the extent of the lesser of: (1) the stock's

FMV on the date of exercise minus the option price; or (2) the amount realized on the disposition minus the basis of the ISO stock (i.e., the stock you acquire through an ISO exercise).

For example, assume again that you buy $150,000 worth of your company's stock for $100,000 by exercising the ISO and later sell this stock for $200,000. The spread between the value on the date of exercise ($150,000) minus the option price ($100,000) would be $50,000. The difference between the amount realized on the disposition of the stock ($200,000) minus the option price ($100,000) would be $100,000. Consequently, your $100,000 gain on the premature disposition would be ordinary income to the extent of $50,000—the lesser of $50,000 or $100,000.

If you receive less on the premature disposition than the value when you exercised the ISO and the disposition wasn't a sale to a related taxpayer, then the taxable amount is limited to the amount you realized on the sale minus your adjusted basis in the ISO stock. For example, if you sold the stock for $130,000, then you would have $30,000 of compensation income ($130,000 amount realized less $100,000 adjusted basis).

Although your ISO has a five-year exercise period, the tax rules that apply to ISOs require that you exercise the option no later than three months after you terminate your employment. There are some exceptions to this employment requirement if you transfer from one related company to another, such as from a parent to a subsidiary.

For stock acquired under options exercised after Oct. 22, 2004, any remuneration that arises when stock is transferred on the exercise of an ISO or on the disposition of the stock is not subject to FICA or FUTA taxation. Additionally, any income resulting from a disqualifying disposition of stock acquired under an ISO is not subject to withholding.

The special tax treatment allowed to taxpayers for regular tax purposes when an ISO is exercised—i.e., no taxation at the time the ISO is exercised, deferral of tax of the benefit associated with the ISO until disposition of the stock, and taxation of the entire profit on the sale of stock acquired through ISO exercise at capital gain rates if ISO holding periods are met—isn't allowed for AMT purposes. Under the AMT rules, you must include in your AMT income, in the year the ISO stock becomes freely transferable or isn't subject to a substantial risk of forfeiture, the bargain purchase price, which is the difference between the ISO stock's value and the lower price you paid for it. For most taxpayers, this occurs in the year the ISO is exercised. This means that even though you aren't taxed for regular tax purposes, you may still have to pay AMT on the bargain purchase price when you exercise the ISO, even though you don't sell the stock, and even if the stock price declines significantly after you exercise the ISO. Under these circumstances, the tax benefits of your ISO will clearly be diminished. However, for tax years beginning after Dec. 20, 2006, the potential harshness of this result is ameliorated by the availability of a partial refund for unused AMT credits that are more than four years old.

Clearly, the rules governing incentive stock option awards are technically complex and call for some careful tax planning strategies to be used. Please call if you would like to discuss any of these matters in more detail.

Piascik & Associates, P.C., provides premier tax, business, and financial services to a broad range of clients throughout the United States, Canada, UK, Germany and abroad. For more information, please visit www.piascik.com, or call Ryan L. Losi directly at (804) 228-4179.

Very truly yours,

PIASCIK & ASSOCIATES, P.C.

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