Understanding incentive stock options

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Companies often reward management or key employees by granting them incentive stock options (ISOs). With this type of option, the employee is provided the right to purchase employer stock at a fixed price in the future.

Nonqualified stock options (NQSOs) also allow employees to purchase company stock at a predetermined price in the future. But ISOs are subject to a more favorable tax treatment than NQSOs because they:

- Can be exercised and sold without recognizing ordinary income, meaning the entire gain (including the bargain element; see Page 2) could be taxed at the generally more favorable capital gains tax rates
- Can potentially be exercised without any tax consequences at all until ultimately sold

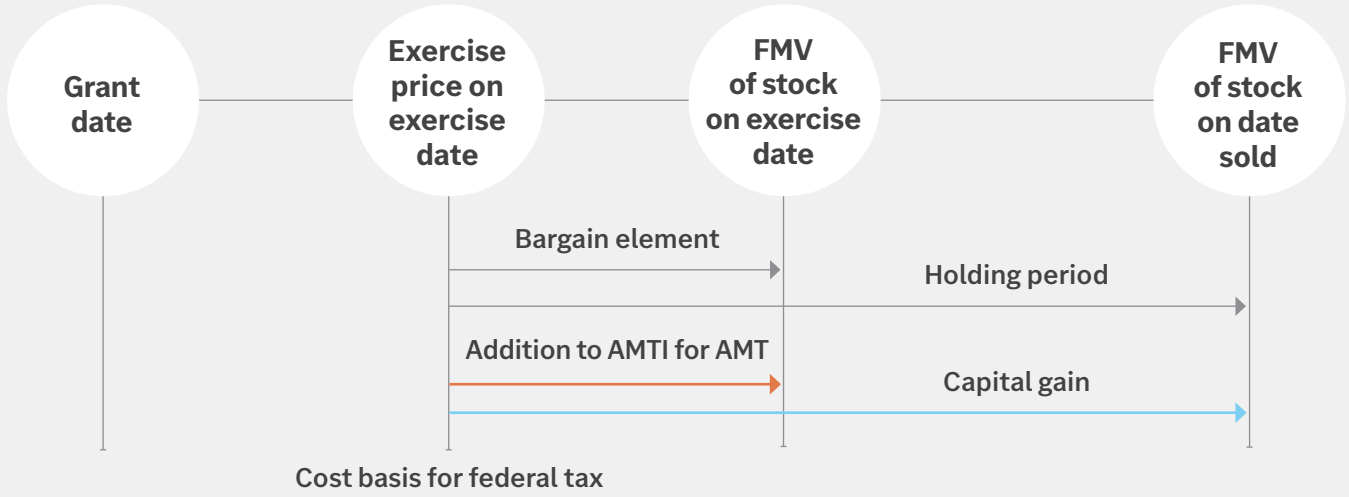
How ISOs work — and are taxed

To achieve this favorable tax treatment, certain timing and exercise restrictions may apply:

1. **Holding period requirements —** To ensure the sale of the stock acquired through an ISO is not taxable as ordinary income, the stock must be sold through what is called a qualifying disposition. This means the individual must hold the stock for:
   - Longer than two years past the grant date, and
   - Longer than one year past the exercise date
2. **Ownership limitations —** ISO holders generally can't own more than 10% of the total combined voting power of all classes of company stock.
3. **Exercise limitations —** For an ISO being exercised for the first time, the fair market value (FMV) is limited to $100,000 per year. Amounts beyond $100,000 will be treated as an NQSO.
4. **Employment considerations —** If you are granted an ISO, you must exercise it while you're employed at the issuing firm or within three months of leaving the firm if the option hasn't expired.

This chart outlines the typical tax consequences of ISOs:

Tax consequences of ISOs (qualifying disposition)



What is the bargain element?

The bargain element represents the discount on shares acquired. It's calculated as the difference between the FMV and the price paid to acquire the shares (also known as the exercise price). Ultimately, this increases your alternative minimum taxable income (AMTI) when determining whether you are subject to alternative minimum tax (AMT). It is this bargain element of the ISO that receives favorable tax treatment if it is a qualifying disposition.

As a hypothetical example, let's say you're granted the option to purchase 100 shares of company stock at $10 per share after a three-year vesting period. Four years later, you purchase the shares when the FMV is $13 per share. Five years after the exercise date, you sell the shares for $19 per share.

Key dates	Grant date	Vesting date	Exercise date	Sale date
Tax implications	N/A	N/A	$13 FMV – $10 exercise price $3/share bargain element, which increases AMTI	$19 sale price – $10 cost basis $9/share long-term capital gain

Source: Edward Jones. For illustrative purposes only; not representative of any specific stock.

A word about alternative minimum taxable income (AMTI)

In the year an ISO is exercised, the bargain element will increase a taxpayer's AMTI. If the taxpayer is subject to AMT as a result, they will get a tax credit to offset future years' federal income taxes. This credit for prior-year minimum tax can be carried forward indefinitely to offset federal income taxes in years in which the taxpayer does not incur AMT.

Disqualifying dispositions

If you fail to meet the holding requirements outlined previously, this can result in what's known as a disqualifying disposition. When you sell your shares, the bargain element is taxed as ordinary income (subject to marginal tax rates) instead of the generally more favorable capital gains tax rates.

Using the previous example, on the date of sale, you would recognize $3 per share in ordinary income and $6 per share in capital gains.

When should you exercise your ISOs?

When there's a bargain:

You should consider exercising options when the FMV is greater than or equal to the exercise price. Otherwise, it may be more advantageous to purchase shares directly instead of exercising options.

If the FMV is below the exercise price and your employer doesn't offer its stock for direct purchase, you must decide based on your risk tolerance whether acquiring company stock for a price above the market price is worth the investment.

Time-sensitive reasons:

You should always assess your financial situation before considering any tax implications. There may be time-sensitive reasons for exercising your ISOs, such as:

- An immediate cash need (such as paying down debt) to strengthen your financial position
- Options that are close to lapsing

What if you're short of funds?

A cashless exercise lets you exercise and then immediately sell enough shares to cover the cost associated with exercising. When determining the value of shares to sell, you should consider the price to purchase the shares and any tax implications of exercising and selling.

Keep in mind, ISO shares sold under a cashless exercise will be considered a disqualifying disposition. On the other hand, your remaining shares will be taxed according to the holding period rules mentioned above.

Opportunistic exercise:

If the preceding situations do not apply, you may be able to consider opportunistically exercising your options based on a tax-efficient strategy, depending on your tax situation.

If you expect to be subject to AMT — Consider exercising when the market is down or the stock's FMV is low. The smaller spread between the FMV and the exercise price will result in a smaller AMTI adjustment, reducing your total AMT.

Using the previous example, if you exercised your options when the FMV was $11 per share, you could expect these tax implications:

Key dates	Grant date	Vesting date	Exercise date	Sale date
Tax implications	N/A	N/A	$11 FMV – $10 exercise price $1/share bargain element, which increases AMTI	$19 sale price – $10 cost basis $9/share long-term capital gain

Source: Edward Jones. For illustrative purposes only; not representative of any specific stock.

If you don't expect to be subject to AMT — Consider exercising options only up to the point you are confident you will stay below AMT limits. You may want to gradually exercise ISOs to avoid incurring AMT.

Understanding your options

Stock options can be a powerful tool in your progress toward your financial goals. While these options have various rules and tax implications, your financial strategy can serve as a guide for integrating them into your overall portfolio.

The rules and opportunities pertaining to stock options can be complex. Additionally, you'll want to be aware of considerations such as overconcentration that can arise when acquiring employer stock.

We recommend working with your financial advisor and tax professional to help you manage your options. By staying informed and prepared, you can maximize your stock option potential and strengthen your overall financial position.

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