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Now is the time to exercise ISOs

Don't forget to value shares that are purchased before year-end

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Incentive stock options are thought of more favorably than non-qualified stock options because ISOs can create capital gains while NQOs create ordinary income. When employees exercise ISOs, no immediate taxable income is created. By contrast, exercising NQOs creates taxable ordinary income equal to the difference between the market price and the option's strike price (the price at which the employee buys the shares). If an employee hangs on to the shares, it is as if he just bought shares at the market price.

When an ISO is exercised, a new capital-gains holding period is established with the employee's cost basis being the price paid for the stock (the strike price of the option).

The ISO stock holding period begins the day the options are exercised. If the employee holds the stock more than 12 months and recognizes a gain upon its sale, the gain is considered long term and taxed at 15%, not at the 35% rate for short-term gains. If the stock is held less than 12 months, the gain is considered compensation and taxed as ordinary income. ISO stockholders, therefore, have an incentive to hold shares at least 12 months.

But that creates a dilemma. Should ISO shareholders hold the stock and hope for more gains or should they sell immediately after exercise? The costs of being wrong can be dramatic, but not always obvious.

If an employee decides to hold the shares, there is the alternative minimum tax trap to consider.

In calculating the AMT, the difference between the purchase price (option strike price) and the market price is considered income. Importantly, the income is not AMT income if the shares are sold in the same calendar year as the option exercise. This is many times confused with the 12-month period necessary to qualify for long-term gains rates.

Unfortunately, many employees see the price of their ISO stock crash during the year after exercise as they wait for their shares to go long term. Without AMT liability, an ISO stock collapse would damage the stockholder economically but not in terms of taxes — in fact, if the shares are sold below the exercise price, the employee could possibly realize a capital loss. But if the ISO option exercise has triggered an unforeseen AMT liability, the employee could find himself owing significant taxes on worthless stock.

During the tech wreck, much ISO stock dropped to near zero, yet employees still faced enormous taxes on their stock. Adding insult to injury, the Tax Court ruled in March 2005 that the IRS has no obligation to provide relief to taxpayers facing bankruptcy due to AMT liability on worthless stock.

Because of this, employees should exercise their ISOs at the very beginning of the year, giving them a full year to make a sell decision. If the stock falls, they should sell before Dec. 31, which would trigger a short-term gain or loss but eliminate the AMT liability. At year-end, if the stock has risen, they could hold for a few more days in January for the 12-month holding period to be achieved and then sell for a long-term gain.

This approach could trigger the AMT, but the economic gain should outweigh the tax liability.

By contrast, if an ISO is exercised in October, the employee has only a short time before the end of the year to decide whether to trigger the AMT, but nine months still to go in order to qualify for long-term treatment or sell at short-term gain rates and avoid the AMT.

Incentive stock options have proved themselves to be a wonderful device for motivating employees, but they must be managed carefully. The takeaway: Exercise in January for maximum flexibility and remember to value the shares that are purchased before year-end or expect a tax bill in April.

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