

Two items to add to Jan. 4 to-do list

The earlier in 2010 your clients exercise incentive stock options or convert to a Roth, the better

By Robert N. Gordon

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There are few places in the tax law where one can “undo” an earlier taxable act. Exercising incentive stock options and converting a conventional individual retirement account to a Roth IRA are two of these. Since it's possible to optimize any time allowed by the government to take advantage of these opportunities, I suggest looking at them now to see if they make sense for your clients — and then acting as quickly as possible next year.

ISOs and the AMT

Let's look at incentive stock options first. When an employee exercises an ISO, the amount between the exercise/strike price and the current market value becomes the amount to be included in the alternative-minimum-tax calculation. However, if the ISO shares are disposed of in the same calendar year that they are exercised, this amount does not become an AMT item.

If the ISO shares have declined substantially since being exercised, it could be prudent to sell the shares before Dec. 31 and thus eliminate any AMT implications. We would suggest that the employee observe the market price Dec. 31 in the year of exercise and consider selling if the shares have declined.

The shareholder does not have 12 months after exercise to make this decision — only until Dec. 31 of the year of exercise. If the exercise takes place in early January, the holder will have almost a full year to see how the stock has performed. By contrast, if the ISO is exercised in November, your client will have only two months to make this decision. In this case, the more time available to decide, the better.

When an employee exercises an ISO, he or she is treated as having just purchased the shares at the exercise/strike price of the ISO. Any income realized from the sale of the shares is capital in nature, as opposed to ordinary income (it is different with non-qualified employee options). Because of the possibility of achieving a lower long-term capital gains rate, many ISO exercisers hold the stock for at least 12 months hoping to get to long-term status and lower the tax rate to 15%, from 35%.

By exercising in early January, an employee can maximize both possibilities. We suggest that an employee making his or her Dec. 31 observation after participating in a full year of share price appreciation hold out until early January in order to qualify for long-term treatment. If the shares have

declined to the point where the AMT implications will come into play, sell Dec. 31. Exercising later than early January only shortens the time your client has to decide about the AMT.

Roth choices

Although it's always been possible for anyone with annual income below \$100,000 to convert an IRA into a Roth, 2010 will afford greater conversion opportunities because the income ceiling will be gone.

Roth conversion rules allow for the ability to re-characterize, or “undo,” a conversion. This makes sense when the value of the Roth declines substantially, making the tax bite disproportionate to the Roth's value.

The government gives Roth converters the choice to reverse any conversion, but the re-characterization election must be made before the tax filing becomes final for the year of conversion.

For those converting in 2010, that time frame can be stretched to Oct. 14, 2011. Thus, if your client converts Jan. 4, he or she will have 21 months to measure performance. If the conversion takes place in November 2010, for example, the maximum time will be cut to 11 months.

Making the decision to re-characterize a depreciated Roth even more practical is the ability to convert the re-characterized IRA back into a Roth the following calendar year at a lower value and thus a lower tax. There does not seem to be a limit on how many times a very unlucky investor could conceivably convert, re-characterize and convert again.

Re-characterization can be further enhanced by utilizing multiple Roth accounts and making separate re-characterization decisions, depending on the performance of each Roth account.

I'm sure the question of who should and shouldn't convert will be hotly debated. But one thing seems clear — anyone who is going to convert should do so in the beginning of the year to maximize the amount of time for making the critical re-characterization decision.

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