

Abstract: Incentive stock options are a popular form of compensation for executives and other key employees. They're a nice perk, but careful tax planning is required because of the complex rules that apply. This article discusses their advantages and offers some tips on managing the tax impact on the 2019 tax year, as well as in the future.

Careful tax planning required for incentive stock options

Incentive stock options (ISOs) are a popular form of compensation for executives and other key employees. They allow you to buy company stock in the future at a fixed price equal to or greater than the stock's fair market value on the ISO grant date. If the stock appreciates, you can buy shares at a price below what they're then trading for. But careful tax planning is required because of the complex rules that apply.

Tax advantages abound

Although ISOs must comply with many rules, they receive tax-favored treatment. You owe no tax when ISOs are granted. You also owe no regular income tax when you exercise ISOs. There could be alternative minimum tax (AMT) consequences, but the AMT is less of a risk now because of the high AMT exemption under the Tax Cuts and Jobs Act.

There are regular income tax consequences when you sell the stock. If you sell after holding it at least one year from the exercise date and two years from the grant date, you pay tax on the sale at your long-term capital gains rate. You also may owe the 3.8% net investment income tax (NIIT).

If you sell the stock before long-term capital gains treatment applies, a "disqualifying disposition" occurs and a portion of the gain is taxed as compensation at ordinary-income rates.

2019 impact

If you were granted ISOs in 2019, there likely isn't any impact on your 2019 income tax return. But if in 2019 you *exercised* ISOs or you sold stock you'd acquired via exercising ISOs, then it could affect your 2019 tax liability. It's important to properly report the exercise or sale on your 2019 return to avoid potential interest and penalties for underpayment of tax.

Planning ahead

If you receive ISOs in 2020 or already hold ISOs that you haven't yet exercised, plan carefully when to exercise them. Waiting to exercise ISOs until just before the expiration date (when the stock value may be the highest, assuming the stock is appreciating) may make sense. But exercising ISOs earlier can be advantageous in some situations.

Once you've exercised ISOs, the question is whether to immediately sell the shares received or to hold on to them long enough to garner long-term capital gains treatment. The latter strategy often is beneficial from a tax perspective, but there's also market risk to consider. For example, it may be better to sell the stock in a disqualifying disposition and pay the higher ordinary-income rate if it would avoid AMT on potentially disappearing appreciation.

The timing of the sale of stock acquired via an exercise could also positively or negatively affect your liability for higher ordinary-income tax rates, the top long-term capital gains rate and the NIIT.

Nice perk

ISOs are a nice perk to have, but they come with complex rules. For help with both tax planning and filing, please contact us.

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