

Avoiding Tax Nightmares When Exercising Incentive Stock Options (ISO's)

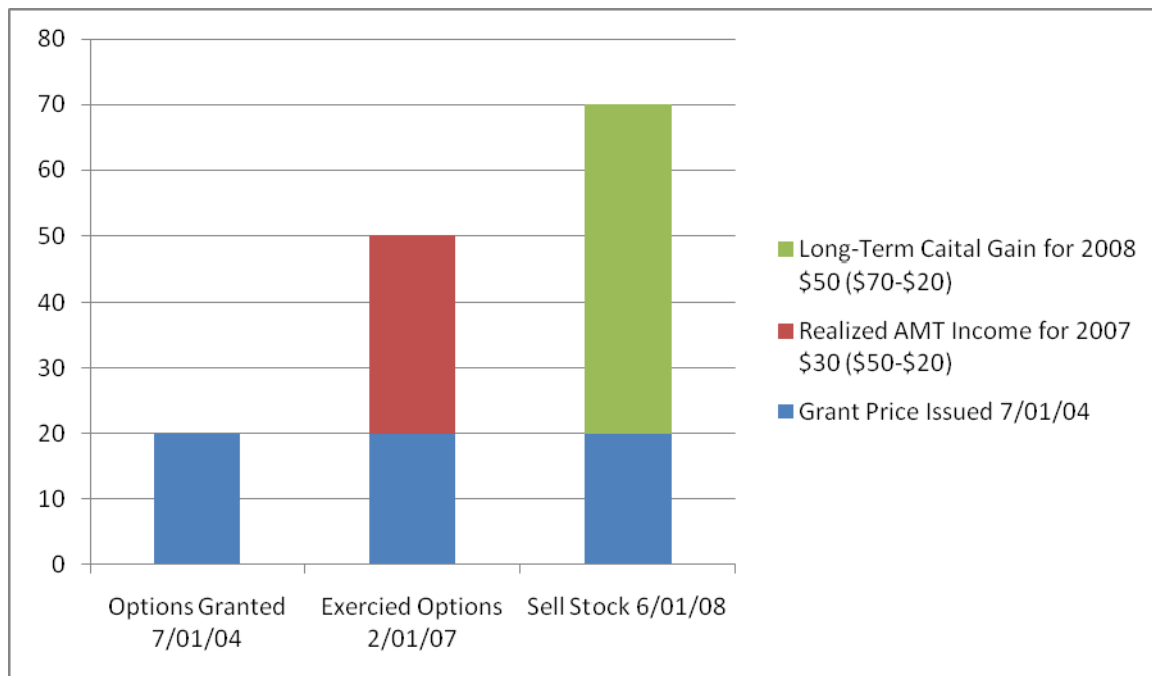
Jeffrey Chou, a former hardware engineer with Cisco, saw his millionaire dreams crumble with the stock market meltdown in 2000 and 2001. Chou exercised his Cisco ISO's in March of 2000 with an estimated profit of \$6.5 million when the shares were trading above \$60 dollars. Chou watched as Cisco shares continued to drop, but he missed the December 31st deadline to sell the shares and avoid the AMT tax. He would ultimately owe the state and federal government \$2.5 million in taxes. Even if he were to sell his three-bedroom town home, cash in his 401(k) account, liquidate all his assets and hand it all over to the IRS, he would still be \$700,000 short.

Thousands of tax payers were in similar binds after losing the game of roulette that so many ISO holders play when they try to take advantage of the capital gains rule. Many ISO holders are simply told if you hold the stock from date of exercise for one year, you get the best results - not understanding the true tax implications. Jeffrey Chou's story about exercising his ISO's may be extreme, but make no mistake about it: the IRS will not overturn a tax assessment just because the law is unfair. Just ask Ron Speltz from ELY, Iowa; a former manager at McLeod USA making \$75,000 a year who was forced to sell his newly built home when exercising his McLeod ISO's in 2000.

Currently the alternative minimum tax (AMT) affects approximately 4 million tax payers with estimates of affecting 35 million tax payers by 2010. The AMT was originally enacted in 1969, and has turned into much more than a parallel taxation system, adding layer upon layer of complexity. Unfortunately, most tax payers who are subject to AMT are unaware of it until they prepare their tax returns, and by then it's too late. Therefore, careful planning in the year of exercising ISO's is critical to reduce or eliminate AMT.

Determining if a taxpayer is subject to AMT requires the tax liability to be calculated twice: first using the regular tax rules, then using AMT rules (parallel tax system). If the AMT calculation produces a higher tax liability than the regular tax rules, the tax payer then will be subject to AMT.

The tax consequences of exercising ISO's can be daunting but ultimately is based on timing. When an employee exercises an ISO, they are not subject to ordinary income tax, social security or Medicare tax. Also there is no tax withholding by the employer at the time of exercise. The difference between the exercise price and market price (bargain element) is subject to AMT if the shares are held through the end of the calendar year of exercise. If the shares are held for more than two years after the grant date and more than a year from exercise then the gain between the sales price and exercise price is taxed at a long-term capital gain rate (qualifying disposition).



With the spread between ordinary income tax and long-term capital gains more than double, there is a lot of motivation to hold ISO shares after exercise to obtain long-term capital gain rates. As indicated earlier, if the stock drops substantially, as in the case of McLeod and CISCO, the option holder may end up with a lot of AMT tax, but little in the way of stock value to pay those taxes.

Then what is the best strategy? First, realize that if the shares of ISO stock are sold in the same calendar year as exercised they are not subject to AMT. Therefore, exercising incentive stocks options early in the year gives the option-holder plenty of time to sell the shares before the end of the year, if the stock drops to avoid the AMT. For example, assume Joe exercises his ISO's in July with a \$20/share grant price when the stock is trading at \$50/share. There is no immediate tax on the \$30 bargain element but the \$30/share is subject to AMT. These paper profits from exercised options generate no cash to pay taxes on AMT income. Joe is told that if the shares are held for one year from exercise and two years from grant date, the gain upon the sale of the shares is taxed at long-term capital gains rates (currently 15% maximum) versus ordinary income rates (currently 35% maximum). Joe's accountant tells him that the entire \$30 bargain element is subject to 26% AMT tax, meaning Joe will own tax of about \$7.80/share, but will receive an AMT credit the following year against his regular tax. Joe continues to hold the stock until July of the following year, but unfortunately the stock has now dropped to \$30/share incurring a capital gain for regular tax purposes of \$10/share and a capital loss for AMT purposes of \$20/share, having AMT virtually wiping out all gains.

As an alternative, if Joe saw the stock starting to drop and sold the shares before the end of the year (disqualifying disposition) he would pay regular income tax on the *lesser* amount of the bargain element at the time of the exercise \$30 (\$20-\$50) or the actual profit on the sale of \$10 (\$20-\$30).

If Joe exercises the ISO's early in the year, he has minimized the period after December 31st that he needs to hold the shares before making a decision to sell. The later in the year he exercises, the greater the risk that in the following tax year the price of the stock could fall. The biggest mistake Joe could make is to wait until after December 31st to sell his shares, but sell them before the one year holding period. He then would be subject to AMT and would pay ordinary income on the lesser of the bargain element or the actual gain. Furthermore, if the option-holder is in the maximum 35% income tax bracket, the long-term capital gain tax benefit is maxed out by holding only 35%-40% of the exercised shares. The remaining 60%-65% of the shares could be sold at exercise and taxed as ordinary income to pay the necessary tax, and these shares would not be subject to AMT.

Finally, remember that AMT is a parallel tax system, so when exercising ISO's it may make sense to increase ordinary income. This can be accomplished in a number of ways, including exercising nonqualified stock options or taking a bonus early so that regular income tax is at or about the AMT level.

ISO's provide a tax benefit to employees who understand the complexities as well as the risks and strategies of holding the shares long enough to be eligible for the special tax rates. As illustrated, employees who hold their ISO shares after exercise without realizing the consequences may find themselves prey to the IRS.

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