

Effect of Tax Increases on Stock Options

In response to current economic conditions, the Obama Administration has postponed tax increases in the short term. However, most analysts project a rise in tax rates after 2010. As a result, we have received a lot of questions that go something like this: "Should I exercise my options now before tax rates increase in the future?" This is not a simple yes/no answer, and is based off four separate pieces of criteria.

First, we need to know when the options expire. As a general rule, the longer the expiration the more valuable the option. This theoretical worth of an option's potential is called time value.

Second, we need to know what the grant price is relative to the stock. This difference is referred to as the 'bargain element,' or the intrinsic value. The greater the intrinsic value, the less theoretical value the option has.

Third, we need to assign a growth rate for the underlying stock if we choose not to exercise. Furthermore, we also require a rate of return that would be obtained from the proceeds of the options sale, assuming a cashless exercise.

Finally, we have to make some assumptions about what future tax rates will be.

Obviously many variables go into calculating if and when to exercise options. For this example we are going to assume the options are nonqualified and that a cashless exercise is performed. Listed below are the details and assumptions used in this example.

- Number of Shares: 5,000
- Exercise Price: \$20/share
- Current Stock Price: \$35/share
- Expiration: 7-1-14
- Current Maximum Federal Tax Rate: 35%
- Future Maximum Federal Tax Rate: 45%
- Growth Rate of Underlying Stock: 10%
- Growth (Net of Taxes) Diversified Portfolio: 6%
- Subject to Medicare Tax Only (Social Security Maxed Out): 1.45%

	<u>Cashless Exercise</u>	<u>Deferral</u>	
Gross Value	75,000	75,000	($\$35 - \$20 \times 5,000$)
Taxes Paid on Exercise	<u>(27,338)</u>		$(35\% + 1.45\% \times 75,000)$
Amount to Reinvest	47,662		
Growth Dividend Portion in 5 Years	63,783		$(6\% \times \$47,662 \times 5 \text{ years})$
Growth Options		120,788	$(10\% \times \$75,000 \times 5 \text{ Years})$
Taxes Paid on Exercise		<u>(56,106)¹</u>	$(45\% + 1.45\% \times \$120,788)$
After-Tax Proceeds		64,682	

¹ If tax rates increased to 40% versus 45% the tax would be \$50,067, with after-tax proceeds of \$70,721.

Many other factors should be considered when determining to exercise now versus deferring. Some of these factors would include: executive's concentration to the employers stock, current and future tax rates, risk tolerance, other options held, potential for future, potential for future grants being issued, and the ability for an executive to obtain financial independence with their options.