Leveraging Existing Shares of Stock to Exercise Options

More Shares, Less Tax

Using existing shares of stock to exercise options can reap additional benefits for executives who own shares of company stock and are allowed to pay the exercise price of their options with the stock they own. In fact, there's a two-fold bonus: more shares than the number exchanged with less of a tax liability.

Before I explain how this works, it is important to determine whether the stock options are nonqualified (NQ) or incentive (ISO). In the case of NQ options, the option holder reports compensation income equal to the value of the additional shares of the option, and this becomes the basis of the additional shares. There is a tax-free exchange for the shares turned in to exchange shares to pay the exercise price, and a separate tax treatment for these exchange shares.

For example, Steve has a non- qualified option to buy 10,000 shares at $10/share (The $10.00 per share is commonly referred to as the strike price). The stock is currently trading at $40 per share. To exercise the option, Steve can either pay $100,000 in cash or he can exchange $100,000 worth of shares he already owns. If he decides to exchange shares he would need to furnish and exchange 2,500 shares ($100,000÷40=2,500). He *exchanges* 2,500 previously owned shares to exercise an option for 10,000 shares, and increases his holdings by 7,500 shares *without paying any cash*.

Here's the kicker: If Steve simply *sells* 2,500 previously owned shares for $100,000 and uses the *cash* to exercise the option, he achieves the same result but with a far different tax result. By *exchanging* 2,500 shares:

- Steve does not have to come up with the cash of $100,000
- Steve does not have to pay any capital gain on the sale of the 2,500 exchange shares
- Steve creates a tax-free transaction for the exchange shares

And here's why: When an option holder uses previously owned shares to pay the exercise price of a NQ option, the IRS views the transaction as having two parts. One part is the *exchange of the shares* that were owned for the same number of identical option shares *(exchange shares)*. These shares keep the same basis and holding period as the date that Steve acquired the 2,500 shares. The other part of the transaction is the *exercise of* 7,500 option shares. In this part of the transaction, Steve would report on his tax return compensation income of $300,000 (7,500 shares x $40 per share). The amount of income reported becomes the basis for the remaining shares in the exchange, and the holding period begins on the day the options are exercised.

Economically, Steve could have achieved the same result had he sold the 2,500 shares for $100,000 and then used the cash upon exercising the option. However, by exchanging 2,500 shares, he did not have to come up with the cash of $100,000 ($10 strike price on 10,000 shares) and he did not have to pay any capital gain on the sale of the 2,500 exchange shares, creating a tax-free transaction for these exchange shares.

If the option holder owns ISOs, it is important to know if the shares were acquired by an earlier exercise of ISOs and if these shares have met the required holding period, a year from the grant date and 1 year from the exercise date, to avoid a disqualifying disposition. If the previous ISO shares were not held for the required period, an anti-pyramid rule comes into play and favorable exchange treatment is not allowed. However, if the ISO shares were not a disqualifying disposition, the option holder does not report compensation income on the exercise of the option. Following the above example, Steve's additional 7,500 shares would have a basis of 0, and the 2,500 shares would retain their original basis. Like any ISO, if the additional shares are held for more than one year, a gain is treated as long-term capital gain versus compensation income.

There you have it: an option exercise strategy that optimizes profits well beyond the use of cash.