

Hedging Your ISO Stock mso+

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Hedging ISO stock raises special issues we did not discuss in our article series on strategies for [hedging concentrated stock positions](#) and on [hedging employee stock options](#) (which focused on NQSOs). This article covers the complexities and a solution for hedging ISO stock.

The Dilemma

A few years ago your company, Micromillion, granted you 100,000 employee stock options in the form of incentive stock options (ISOs). The options allowed you to acquire Micromillion stock at price of \$10 per share (the exercise price).

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Now you want to exercise those options. Yesterday Micromillion was selling in the market at \$110 per share. You assume if you exercise your options you'll hold the stock because you think it will climb even higher. Plus, you want to receive the special favorable tax treatment for ISO stock that you sell more than one year after exercise.

Now your cousin Ernie's telling you to watch out. Ernie works at Cyberdotcom, and he exercised his employee stock options two years ago. He thought he'd made a lot of money, but right after he exercised the ISOs and held the stock, Cyberdotcom went out of business and the stock became worthless. Then tax time came around, and he discovered that he owed an enormous tax on that worthless stock due to the [alternative minimum tax](#) (AMT). He sold his house and borrowed money from his parents to pay that bill.

Ernie says that if you exercise your options, you should sell your Micromillion immediately. He says his (new) accountant tells him he should have sold his Cyberdotcom stock on the day of exercise.

So what should you do?

Two Types Of Employee Options

Nonqualified stock options (NQSOs) trigger a tax when they are exercised: you are taxed on the spread, regardless of whether you sell or hold the stock at exercise. If you decide to hold your nonqualified shares at exercise, sitting on a large paper profit, you may want to hedge them. As discussed in our articles on [hedging NQSOs](#), strategies exist to help you hedge NQSOs and stock from NQSO exercises. You can review these strategies with your own tax and legal counsel.

As explained in other FAQs and articles on this website, ISOs qualify for special tax treatment: their exercise does not trigger an immediate income tax if you hold the stock you receive upon exercise. ISOs are regarded as more tax-favored than NQSOs. But this perception may be wrong.

More On ISO Stock Taxation

When you sell ISO stock held more than one year after exercise, you realize long-term capital gain or loss equal to the difference between the stock's basis (the options' exercise price) and the sale price.

But there's a catch. In addition to this treatment, ISO exercise may also trigger an unexpected AMT. In computing your AMT income, you must include the spread between the exercise price and the fair market value of your ISO stock on the day you exercised your options.

The AMT does not apply if you sell your shares in the year the options are exercised. If you do that, the sale will create ordinary income on the spread at exercise. That ordinary income is taxed at the top rate of 35%, with short-term capital gains on any appreciation since exercise. Should the stock price decline

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after exercise, your compensation income is your actual gain (sale price minus exercise price). See the [relevant FAQs](#) on this website for more details and examples of ISO stock sales. But if the stock has declined since the exercise, this tax may be much less than the AMT, which is based on the spread at exercise. **unaware of the AMT.**

Unfortunately, many employees with ISO stock are dangerously unaware of the AMT. This danger is compounded because ISO stockholders have a well-known tax incentive to hold their ISO stock at exercise. The ISO stock-holding period begins on the day the options are exercised. If you hold your ISO stock more than 12 months and recognize gain upon its sale, the gain above your exercise price will be taxed at long-term capital gains rates (15%) as opposed to 35% for short-term gain.

The Potential Tax Disaster

Unfortunately, many employees have seen their ISO stock drop substantially during the year after exercise.

The ISO exercise can trigger an unforeseen AMT liability, causing you to owe huge taxes on worthless stock. This is what happened to Ernie. During the tech wreck, much ISO stock dropped to near zero, but the employee stockholders still faced enormous taxes on that stock. In March 2005, the [US Tax Court](#) ruled that the IRS has no obligation to provide relief to taxpayers facing AMT liability on worthless stock.

How To Handle Your Stock

First, you should consult your tax advisor before you exercise ISOs. The AMT is complicated, and you may be able to recover some of this tax in future years. So you will need professional advice that is tailored to your circumstances.

Hedging ISO Stock

You cannot hedge ISOs before exercise, as most experts would say this disqualifies them as ISOs and turns them into NQSOs. However, Twenty-First Securities has discovered a technique for hedging ISO stock after exercise. This financial engineering creates a floor under the stock while still accruing the holding period. By letting the holding period continue, you can reach that one-year mark for long-term capital gains on the sale.

The strategy involves borrowing against the shares. The method is intriguing because the loan will be recourse only against the shares pledged. If the stock appreciates, you can either re-borrow or repay the loan and have the shares returned. If the stock declines, you can simply walk away from the shares and keep the borrowed cash, which may equal up to 95% of the shares' value at the time of the borrowing.

A technique for hedging ISO stock creates a floor under the stock while still accruing the holding period, letting you reach the one-year mark for long-term capital gains.

The loan provides protection that is in many ways similar to that of a put option. However, we are advised that it should not be taxed as a put. From a tax perspective, this single-recourse loan may be the most efficient way to borrow against equities. Since the debt payments would not be tied to the stock value, we are advised that the loan should not create a straddle or stop the holding period on the stock. The strategy has some limitations. For example, the lender has a \$3 million minimum for these types of loans.

Protective Timing

If you cannot engage in a nonrecourse loan, you should exercise your ISOs at the very beginning of the year and then keep an eye on the stock. If the stock falls, you should sell before year-end, triggering an ordinary income tax but eliminating the AMT. At year-end, if the stock has risen, you can wait until early January to sell it for a long-term gain and then use some of the money to pay your taxes. This approach can trigger the AMT, but the economic gain should outweigh the tax liability.

Editor's Note: Options involve risk and are not suitable for all investors. Before engaging in an options transaction, you must review the options disclosure document [Characteristics And Risks Of Standardized Options](#).

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