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THE TAX-CONSCIOUS ADVISER

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Keep your eyes on the calendar

When it comes to re-characterizations and incentive stock options, timing is critical

December 15, 2013 - 12:01 am EST

Roth conversion rules allow an investor to re-characterize, or undo, a conversion. This makes sense when the value of the Roth declines substantially, making the tax bite disproportionate to the Roth's value. The government gives Roth converters the choice to reverse any conversion.

That re-characterization election may be made any time before the tax filing becomes final for the year of conversion. For those converting in 2014, that time frame could stretch until October 2015. Thus, if you convert Jan. 4, you will have 21 months to measure performance. Alternatively, if the conversion takes place in November 2014, for example, the maximum time will be cut to 11 months.

To further maximize the re-characterization possibility, investors should utilize multiple Roths so that they can keep the one that has performed well and re-characterize the Roths that didn't do so well. One thing seems clear: Anyone who is going to convert should do so in the beginning of the year to give themselves the maximum amount of time to be able to see how the investments perform, and then make the critical re-characterization decision.

Incentive options

Incentive stock options are thought of more favorably than nonqualified stock options because ISOs can create capital gains, while NSOs create ordinary income.

When employees exercise ISOs, no immediate taxable income is created. When an ISO is exercised, a new capital gains holding period is established, with the employee's cost basis being the price paid for the stock (the strike price of the option).

The ISO stock holding period begins the day the options are exercised. If the employee holds the stock more than 12 months and recognizes a gain upon its sale, the gain is considered long-term. If the stock is held less than 12 months, the gain is considered compensation and taxed as ordinary income. ISO stockholders, therefore, have an incentive to hold shares at least 12 months.

But that creates a dilemma. Should ISO shareholders hold the stock and hope for more gains or should they sell immediately after exercise? The costs of being wrong can be dramatic but not always obvious.

If an employee decides to hold the shares, there is the alternative-minimum-tax trap to consider.

In calculating the AMT, the difference between the purchase price (option strike price) and the market price is considered income. Importantly, the income is not AMT income if the shares are sold in the same calendar year as the option exercise. This is often confused with the 12-month period necessary to qualify for long-term gains rates.

Unfortunately, many employees see the price of their ISO stock crash during the year after exercise as they wait for their shares to go long-term. Without AMT liability, an ISO stock collapse damages the stockholder economically, but not in terms of taxes. In fact, if the shares are sold below the exercise price, the employee could possibly realize a capital loss. But if the ISO option exercise triggers an unforeseen AMT liability, the employees could find themselves owing significant taxes on worthless stock.

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Because of this, they should exercise their ISOs at the very beginning of the year, giving them a full year to make a sell decision that would have no AMT impact. If the stock falls, the employees should sell before Dec. 31, which will trigger a short-term gain or loss but eliminate the AMT liability. At year-end, if the stock has risen, they can hold for a few more days into January for the 12-month holding period to be achieved, and then sell for a long-term gain. This approach could trigger the AMT, but the economic gain should outweigh the tax liability.

By contrast, if an ISO is exercised in October, employees have only a short time before the end of the year to decide whether to sell before Dec. 31 and avoid the AMT or hold for nine months more in order to qualify for long-term treatment.

Incentive stock options have proved themselves a wonderful device for motivating employees, but the investments must be managed carefully. In short, exercise in January for maximum flexibility and remember to observe value of the shares that are purchased before year-end, or expect a possible AMT tax bill in the following April.

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