

## StockOptions

### How Tax Rate Changes Impact Strategies For Stock Options & Restricted Stock (Part 1)

Stanley Trotta with Robert Gordon

You believe a tax hike is on the horizon, whether in 2009 or when the current rates expire after 2010. This leads you to consider re-evaluating your current financial-planning strategy for your equity compensation and current company stock holdings to determine whether immediate action is required this year or before new rates apply.

This article series looks at whether the likelihood of tax rate changes should drive your decisions to exercise stock options or to sell stock that you received from an option exercise or restricted stock vesting. Part 1 looks at nonqualified stock options (NQSOs) and restricted stock. Part 2 will analyze incentive stock options (ISOs).

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**Should you take action with your stock options and restricted stock now or wait for new tax rates?**

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#### NQSOs

Your equity compensation package may include nonqualified stock options (NQSOs), as they are the most common form of stock option grant. As with all employee stock options, they allow you to purchase company stock at a preset price (i.e., the exercise or strike price). This right to purchase the stock is usually limited to a term no greater than 10 years (check your grant agreement for specifics on the term and vesting). As a component of compensation, NQSOs are subject to ordinary income tax rates when the options are exercised. It is at this point that the difference between the fair market value (FMV) of the company stock and the exercise price (i.e., the bargain element or spread) is treated as wages and subject to taxation. (For more tax and reporting details, see [NQSOs: Taxes and the relevant sections of the Tax Center.](#))

Let us explore some considerations for your NQSOs when tax rates go up.

**Example:** You have 1,000 NQSOs with an exercise price of \$10. The current fair market value (i.e., current trading price) is \$15. Your federal tax rate for additional income (i.e., your marginal tax rate) is 35%. The NQSOs will expire in three years (within the next presidential term, so waiting for a subsequent presidential administration is not an option). To simplify the example to isolate the impact of a federal tax rate increase, your state does not have an income tax and you have maxed out on your Social Security tax (i.e., only Medicare tax applies).

*Question: Does it make sense to exercise the options, sell the stock, and invest the proceeds from an NQSO before there is a rise in the ordinary tax rate?*

You first determine the current net value of the NQSOs. To keep matters simple, we will assume a "cashless exercise" whereby your taxes and exercise costs are immediately paid for from the stock option value, calculated as follows:

Gross value	\$15,000	(\$15 x 1,000)
Less exercise price	(\$10,000)	(\$10 x 1,000)
Less federal income tax	(\$1,750)	(\$5,000 x 0.35)
Less FICA taxes	(\$73)	(\$5,000 x .0145)
<b>Net value</b>	<b>\$3,177</b>	

When the federal income tax rate rises to 40%, the NQSOs net value drops to \$2,927 (assuming no stock price increase), a decrease of approximately 8%. *This simple observation alone may cause you to act rashly and immediately liquidate the NQSOs.* But that 8% decrease in value should be balanced against the impact of paying taxes three years earlier than necessary.

While it is clear that an increase in ordinary tax rates would have a negative impact on the net value of NQSOs, you must consider the alternative. To determine whether immediate action is required, you should compare a *Hold The Options Unexercised* strategy with an *Exercise, Sell & Invest* strategy.

If you continue to hold your unexercised options, you are still "invested" in your company's stock, which may increase or decrease between now and expiration of the NQSOs. Therefore, you need to factor in the expiration date of the NQSOs to set the time horizon.

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**Estimate the after-tax growth rate of an alternative investment to calculate the break-even point between the**

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If you choose to exercise before the end of the term, perhaps to diversify your net worth away from company stock, you are able to invest the NQSO profits in any manner you find attractive. Therefore, you need to estimate the after-tax growth rate for the replacement investment to calculate a break-even point between the two strategies. You should still do this analysis when your alternative investment is just keeping the sale proceeds in a money market account or putting them in T-bills. It can prevent you from exercising merely because tax rates are likely to go up.

**strategies of either holding unexercised options or exercising, selling, and reinvesting. This analysis can prevent you from exercising merely because tax rates are likely to go up.**

For the above example, the time horizon is set at three years, since NQSOs are typically exercised just prior to expiration. For a *Exercise, Sell & Invest* strategy, the \$3,177 of initial proceeds would grow to \$3,679 by the end of year three, assuming the replacement investment has an after-tax growth rate of 5% ( $\$3,177 \times 1.05^3$ ).

The break-even point for a *Hold The Options Unexercised* strategy will be achieved when your company's stock grows at a 2.77% annual rate, or the share price reaches \$16.28 by the end of year three. At this point, the shares will have grown by \$1.28 and the NQSOs will be worth \$3,677, calculated as follows:

Gross value after 3 years	\$16,280	(\$16.28 x 1,000)
Less exercise price	(\$10,000)	(\$10 x 1,000)
Less federal income tax	(\$2,512)	(\$6,280 x .40)
Less FICA taxes	(\$91)	(\$6,280 x .0145)
<b>Net value</b>	<b>\$3,677</b>	

The following table illustrates the impact an increase in the spread will have on the break-even analysis. You will see that the greater the current spread, the higher the annual growth rate of your company stock must be for the *Hold The Options Unexercised* strategy to break even with the *Exercise, Sell & Invest* strategy.

FMV/stock price at exercise	\$15	\$20	\$25	\$30
Exercise price	\$10	\$10	\$10	\$10
Spread (FMV less exercise price)	\$5	\$10	\$15	\$20
Stock's annual growth rate	2.77%	4.10%	4.89%	5.40%
Average annual required stock price increase over three years	\$0.42	\$0.82	\$1.22	\$1.62

Clearly, the current value of your company's stock will have a significant impact on your decision. In the above case, if the stock was currently valued at \$15, you might choose *Hold The Options Unexercised*, as a 2.77% annual growth rate for the next three years might seem reasonable. However, if your company stock was currently valued at \$30, the bigger spread might cause you to choose *Exercise, Sell & Invest*, if you felt that a 5.4% growth rate for the next three years was not attainable.

The break-even analysis provides the hurdle rate the company stock must beat for a *Hold The Options Unexercised* strategy to be maintained (assuming a cashless exercise). If you expect the company stock will not beat the hurdle rate, the NQSOs should be exercised, the shares sold, and the proceeds redeployed to an alternative investment.

**The break-even analysis provides the hurdle rate the company stock must beat for a *Hold The Options Unexercised* strategy to be maintained.**

*Summary Of Variables*

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Your decision on what to do is based on three main variables: (1) current stock price; (2) exercise price, which, together with the stock price, determines how much your stock options are now in the money (i.e., how much spread); (3) expiration date. It becomes critical for you to evaluate each NQSO grant separately, as they will have different exercise prices and expiration dates. When doing so, you may find that some grants should be exercised now and some grants held. The analysis of whether to continue holding NQSO stock that has appreciated after exercise is similar to the analysis discussed below on whether to sell restricted stock that has appreciated after it vests.

### Restricted Stock

Your equity compensation package may also include restricted stock or restricted stock units (RSUs). Their features are very similar so we will use term "restricted stock" in this article to refer to both. These grants of company stock vest at a future date and have value no matter how much the stock price has dropped since grant.

Due to this future vesting feature and risk of forfeiture, these grants are generally treated as compensation on the vesting date and not on the grant date. At that point, the full fair market value of the shares is taxed at ordinary income rates. (For more tax and reporting details, see Restricted Stock: Taxation.) However, for restricted stock (but not RSUs), you can make a tax election, called a Section 83(b) election, within a 30-day window from grant date. In this way, the restricted stock is taxed immediately according to the stock price on the grant date, and any subsequent gains are then taxed at capital gains rates. Your company will need to withhold tax from you in some way, as you cannot sell the stock itself until it later vests.

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**With a looming tax hike, determine whether immediate action is required. Consider the two times when you have decision-making power with restricted stock.**

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For our discussion, we will assume that vesting and release are on the same date. Some RSU plans have a deferral feature, which, like waiting to exercise NQSOs, can complicate the analysis.

With a tax hike looming, you must determine whether immediate action is required before the tax rate rises. There are two times when you have decision-making power. One is after the restricted stock or RSUs vest, and the other (for restricted stock only) is during a 30-day window from the date of grant.

Let us consider these two scenarios.

#### First Scenario: Keep Holding Appreciated Company Stock

**Example:** You received a restricted stock grant of 10,000 shares at a price of \$5. The restricted stock grant vested and the shares were released at a price of \$10. The shares have appreciated since vesting and are currently valued at \$20.

*Question: Does it make sense to sell the shares now and pay capital gains taxes at the current 15% rate or to hold the shares to a future date, despite a rise in the capital gains rate?*

The following chart demonstrates the negative impact of an increase in the capital gains tax rate:

Tax rate	15%	20%
FMV of restricted stock	\$200,000	\$200,000
Tax basis (FMV at vesting date)	\$100,000	\$100,000
Taxable amount	\$100,000	\$100,000
Less capital gains tax	(\$15,000)	(\$20,000)
<b>Net proceeds</b>	<b>\$185,000</b>	<b>\$180,000</b>

As you saw with the analysis involving NQSOs, the change in capital gains rate alone should not drive a decision to sell the stock now. Although a 33% increase in the capital gains rate from 15% to 20% seems big, its impact on the after-tax gains from your restricted stock is much smaller (in this example of \$185,000 to \$180,000 it's only 2.7%). But a determination that the tax hit was not as large as you might have expected should not cause you to be complacent. You need to determine what it will take in future stock price appreciation (if anything) to recoup the hit by the tax increase. This then lends itself nicely to a *Hold The Stock* strategy vs. a *Sell & Invest* strategy.

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First, you determine the starting point values. For a *Hold The Stock* strategy, the starting point value is \$200,000, as you would simply continue to hold the shares from the restricted stock vesting (you would also use this analysis for stock acquired through an NQSO exercise). Remember that your basis is the vesting date value (for NQSOs, it is the stock price at exercise). For a *Sell & Invest* strategy, your starting point is \$185,000 (with full basis), as demonstrated above. Next, you need to estimate growth rates. To get a sense of how each strategy will play out, let us first assume that the growth rate for each strategy is identical.

**The hike in the capital gains rate alone should not drive a decision to sell now. Determine what it will take in stock price appreciation (if anything) to recoup the hit by the tax increase.**

With a 6% growth rate, you find that a *Sell & Invest* strategy outperforms a *Hold The Stock* strategy through year five, when the capital gains rate is 20%. Then, by year six, a *Hold The Stock* strategy reaches a break-even point and outperforms a *Sell & Invest* strategy, illustrated as follows:

	Hold	Sell & Invest
Starting point	\$200,000	\$185,000
Tax basis	\$100,000	\$185,000
Value at year six (at 6% growth)	\$283,704	\$262,426
Less built-in capital gains taxes at 20%	(\$36,741)	(\$15,485)
<b>Net value</b>	<b>\$246,963</b>	<b>\$246,941</b>

When the growth rate for both strategies is identical, you find that a *Sell & Invest* strategy comes out of the gates strong, but at some future point a *Hold The Stock* strategy catches up and then outperforms a *Sell & Invest* strategy. The rate at which the *Hold The Stock* strategy will catch up is determined by the assumed growth rate for both strategies.

Based upon the above fact pattern, here are the break-even points for a *Hold The Stock* strategy (assuming the capital gains rate is increased to 20%):

Growth rate for both strategies:	1%	2%	3%	4%	6%	10%
Year in which break-even point for hold strategy is reached:	36	18	12	9	6	4

The lower the assumed growth rates, the longer it takes the *Hold The Stock* strategy to catch up. This break-even point will help you decide what to do with your company stock. If you plan on using these funds at some point within this period, you would presumably sell your company stock now, pay the taxes, and invest the proceeds.

However, the growth rate for each strategy is not likely to be the same. Therefore, let us consider what happens when growth rates between the two strategies differ. What is interesting here is that a small difference between the growth rates of either strategy will have a major impact.

*What if the growth rate of the new investment is greater than your company's stock growth rate?*

You may be surprised to find that if the new investment grows at merely 1% greater than your company's stock, a *Sell & Invest* strategy will always outperform a *Hold The Stock* strategy. Under these circumstances, you would presumably sell your company stock, pay the taxes, and invest the proceeds. This would be the case even if the tax rates were not to increase.

*What if the growth rate of your company's stock is greater the growth rate of*

**When the growth rate for both strategies is identical, *Sell & Invest* starts strong, but at some future point *Hold The Stock* catches up and outperforms it. However, when your company stock performs at 1% or greater than a new**

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the new investment?

On the other hand, when your company stock performs at 1% or greater than a new investment does, you find that the break-even point for a *Hold The Stock* strategy is reached within two to three years. Given the likely depressed price of your company's stock and your predictions on how quickly it may recover, this may lead you to hold it even with the tax increase on capital gains ahead.

**investment, the break-even point for *Hold The Stock* is reached within two to three years.**

Now here are the break-even points for a *Hold The Stock* strategy based upon the above fact pattern when your company stock performs at only 1% greater than the new investment:

Growth rate for <i>Hold The Stock</i>	2%	3%	4%	5%	7%	11%
Growth rate for <i>Sell &amp; Invest</i>	1%	2%	3%	4%	6%	10%
Year in which break-even point for <i>Hold The Stock</i> is reached	3	3	3	3	3	2

### Second Scenario: Pay Taxes At Grant

**Example:** You received (within the past 30 days) a grant of 10,000 shares of restricted stock when the current market price was \$5 per share (or you are expecting a restricted stock grant in the near future). The restricted stock grant will vest in two years.

*Question: Does it make sense to elect to have the restricted stock taxed now and pay ordinary taxes at the current 35% rate? Or is it better to wait until vesting to pay the taxes, despite a rise in the ordinary tax rate?*

One benefit of making a Section 83(b) election is that any additional appreciation from grant date to ultimate disposition will be taxed at the capital gains rate. Major drawbacks of making the 83(b) election include the possibility that you may forfeit the restricted stock before it vests, or that the value of the shares may drop significantly by the vesting date.

**Will you make more money by keeping the tax fund invested than you would from the tax savings of an 83(b) election?**

In the wake of a tax increase, a driving factor for making the 83(b) election is the potential tax savings. Remember, to entertain the notion of an 83(b) election, you must have a "tax fund" (i.e., extra cash) to pay the tax immediately at grant instead of waiting to be taxed at vesting. Now, the forgone potential appreciation of the tax fund you used to pay the tax liability resulting from the election will offset the ultimate benefit from the 83(b) election. If you determine the growth rate of return necessary to beat the tax benefit, you can determine whether the *83(b) Election* strategy would make sense. In other words, will you make more money by keeping the tax fund invested than you would from the tax savings of an 83(b) election?

For the above example of the restricted stock grant vesting in two years, you will find the *83(b) Election* strategy is advantageous under the following conditions (assuming an increase in ordinary income tax rate to 40% and the capital gains rate to 20%):

1. When the after-tax annual growth rate for the tax fund used to pay the tax is lower than 6.9% (the break-even rate) from the grant date through the vesting date.
2. When the value of the restricted stock remains constant (no growth).

This analysis, which focuses on the alternative returns for the money used to pay taxes early, can be expressed as follows:

### 83(b) Election

Start with your tax fund [RS grant date value x 35% (current rate)]	\$17,500

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<b>Less</b> the income taxes [RS grant date value <b>35%</b> (current rate)]	(\$17,500)
<b>Add</b> your RS grant date value	\$50,000
<b>Add</b> projected appreciation of RS from grant date to vesting date (we assumed <b>0%</b> )	\$0
<b>Less</b> capital gains tax at <b>20%</b> (future capital gains rate) on the appreciation in RS from grant date to vesting date	\$0
<b>Net future value</b>	<b>\$50,000</b>

versus:

#### Hold

Start with your RS grant date value	\$50,000
<b>Add</b> projected appreciation of RS from grant date to vesting date (we assumed <b>0%</b> )	\$0
<b>Less</b> ordinary tax at <b>40%</b> (future rate)	(\$20,000)
<b>Add</b> tax fund [RS grant date value x <b>35%</b> (current rate)]	\$17,500
<b>Add</b> projected after-tax appreciation on tax fund through vesting date at <b>6.90%</b>	\$2,500
<b>Net future value</b>	<b>\$50,000</b>

In the above example, you would make the 83(b) election if you could not get an annual after-tax growth rate of 6.9% on your tax fund. You will find that if the vesting were extended beyond two years, the required growth rate on the tax fund would become lower. In these cases, it would be less likely that you would make the 83(b) election.

However, we did not factor a growth rate for your company stock. As we noted above, if you make an 83(b) election, subsequent gains on your company stock are taxed at capital gains rates. This is an additional benefit of the 83(b) election. Therefore, when you factor in growth for your company stock, you will find the 83(b) election more attractive, as it would take a much higher growth rate on the tax fund to break even.

For the above example, if you assume that your company stock grows at a 5% annual rate over the next two years, you would make the 83(b) election if you could not get an annual after-tax growth rate of 9.61% on your tax fund, thereby making an 83(b) election more appealing.

This comparative analysis may provide some guidance for your decision-making process. However, you must thoroughly explore the risks of forfeiture or precipitous price declines before making an 83(b) election.

#### No Simple Answers

We looked at the impact of an increase in tax rates. However, given that changes in the world of finance occur almost daily, many other variables may cause you to revise a current strategy. These include the risk associated with holding a single stock, the need to diversify, sudden changes in the quality of the underlying company, your position and future with the company, and possible blackout periods that restrict your ability to exercise at will.

**Clearly, planning with stock options and restricted stock is not for the faint of heart. The back-of-the-envelope calculations will not cut it.**

Clearly, planning with stock options and restricted stock is not for the faint of heart. The back-of-the-envelope calculations will not cut it. You must work with your tax and financial advisors to develop an action plan that is tailored to your specific situation. Regardless of whether you have NQSOs, restricted stock, ESPP stock, or ISOs (to be discussed in Part 2), careful planning and number-crunching are the only ways in which decisions should be made. Constant vigilance is warranted, for immediate action may be required at any time. A thorough understanding of the variables will allow you to explore and develop an appropriate course of action.

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*This article was published solely for its content and quality. Neither the authors nor their firms compensated us in exchange for its publication.*

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### How Tax Rate Changes Impact Strategies For Stock Options & Restricted Stock (Part 2)

Stanley Trotta with Robert Gordon

For the time being, it appears we may have dodged an imminent tax increase. However, President Obama's proposals will probably raise taxes sometime after 2010. This may now be an opportune time to re-evaluate your current financial-planning strategy for your equity compensation and current company stock holdings to determine whether action is required before new rates apply.

This article series provides an analytical framework to help you focus on the impact of a tax hike. The analysis may help with your decision about whether, should your taxes rise, to exercise stock options or to sell stock that you received from an option exercise or restricted stock vesting. Part 1 looks at nonqualified stock options (NQSOs) and restricted stock. Part 2 analyzes incentive stock options (ISOs).

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**Some events, such as a proposed tax increase, may make you wonder whether you should deviate from your current ISO investment plan.**

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Your equity compensation package may include incentive stock options (ISOs). While some of the issues discussed in Part 1 for nonqualified stock options (NQSOs) and restricted stock apply, you have more planning opportunities and more complex taxes with ISOs. As this article discusses, these factors present both opportunities and risks.

#### Quick ISO Tax Review

The difference between the exercise price and the price of the shares at exercise (the spread) is the amount that is subject to taxation, as with NQSOs. However, unlike with NQSOs, the spread at exercise is not immediately subject to ordinary tax rates when you continue to hold the ISO stock after exercise. Instead, you have an opportunity to receive long-term capital gains treatment (currently 15%) on the spread. Better yet, the capital gains tax is imposed only when you ultimately sell your ISO shares. The beauty here is the complete avoidance of the ordinary income tax rate (currently up to 35%). To qualify for this preferential tax treatment, you must meet an overall two-year holding period between the grant date and the sale date and a separate one-year holding period between the exercise date and the sale date.

As it is for NQSOs, your primary goal thus far is to allow the spread on your ISO to grow as much as possible, and then exercise them. With ISOs, depending on your financial needs and your predictions about your company's stock price, you can hold the shares for the required period to obtain the preferential tax treatment. To this end, though more with ISOs than with NQSOs, you have control over the taxes on the *exercise date* and the *sale date*. Depending on when your exercise date and sale date occur, the tax implications of selling your ISO shares will vary. (See the sections ISOs: Taxes and ISOs: Taxes Advanced for more details of the holding-period requirements and the full range of planning issues.)

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**More with ISOs than with NQSOs, you have control over the taxes on the exercise date and the sale date.**

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However, there are some events, such as a proposed tax increase, that may make you wonder if you should deviate from your current ISO investment plan. The perceived harm from a tax increase is the diminution of your ISO's value.

As said before in Part 1, there is no magic to your decision process. You must crunch the numbers to determine the best course of action for your ISOs.

#### Four Alternatives

A proper analysis starts with an assessment of the status of your ISOs. Here are four basic situations in which you may find yourself:

1. You already hold ISO shares from an earlier exercise more than one year ago, and the grant date was more than two years ago.
2. You exercised your ISOs more than one year after grant date, but you have held the ISO shares less than one year from exercise.
3. You have held ISO shares for more than one year after exercise but you have not met the full requirement of two years from the grant date.
4. You hold unexercised ISOs.

#### Steps Of The Analysis

Once you have determined the current status of your ISO position, you can hone in on the impact of a tax increase by running a comparative analysis. Let's look at how you may analyze these various alternatives. You want to determine if you are better off with or without your ISOs should the income tax rates increase. You can determine this in a three-

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step process:

1. Determine your starting point value.
2. Determine your timeframe.
3. Assume a growth rate for your company stock (ISOs) and run a break-even analysis to determine the required rate of return for your alternative investment.

### First Scenario: Holding Stock From ISO Exercise

*You were granted 10,000 ISOs with an exercise price of \$10. You held your options for one year and then exercised them at \$20. You then held the ISO shares for over one year from the exercise date. The shares are currently valued at \$20.*

**Question:** Does it make sense to sell the shares now and pay capital gains tax at the current 15% rate, or to hold the shares until a future date despite a likely rise in the capital gains rate?

Under this scenario, you have met the required holding period for the ISO preferential tax treatment. Therefore, you simply consider the impact of a change in capital gains rate. The following chart shows the difference in net proceeds between the current 15% rate and the likely future 20% rate:

Capital gains tax rate	15%	20%
FMV of ISO shares	\$200,000	\$200,000
Tax basis (exercise price paid on exercise date)	\$100,000	\$100,000
Taxable amount	\$100,000	\$100,000
Less capital gains tax	\$15,000	\$15,000
<b>Net proceeds</b>	<b>\$185,000</b>	<b>\$185,000</b>

This scenario lends itself nicely to comparing a *Hold The Stock* strategy with a *Sell & Invest* strategy.

First, determine the starting point values. For a *Hold The Stock* strategy, the starting point value is \$200,000, just as with any stock you purchased by exercise or on the open market (or any stock you obtained from a restricted stock grant that vested). Remember that your tax basis for the ISO shares is \$100,000. For a *Sell The Stock & Invest* strategy, your starting point is \$185,000 (with this as your basis for the investment) as demonstrated above.

Next, you consider growth rates for your company stock and the alternative investment, even if the alternative is just a money-market account or T-bills. Your analysis needs to consider both growth and tax rates. To get a sense of how each strategy will play out, look at the first scenario with restricted stock in Part 1, as the analysis is similar.

That was easy, since you did not need to consider giving up the preferential tax treatment for your ISOs. Now we move on to the fun stuff. The next scenarios focus on points in time where you have not met the statutory holding periods for attaining the preferential tax treatment offered to ISOs.

### Second Scenario: Holding ISO Stock Less Than One Year

When you think of selling your ISO shares before meeting the required holding period, you must consider the immediate tax consequence of disposing your ISOs. In other words, will you be better off disposing your ISOs before the required holding period is met?

*You held 10,000 ISOs with an exercise price of \$10 for several years. You exercised them six months ago at \$15. The shares are currently valued at \$20. (This assumes no alternative minimum tax.)*

**Question:** Does a disqualifying disposition make sense in light of a likely increase in the capital gains tax rate?

**When you think of selling your ISO shares before meeting the required holding period, you must consider the immediate tax consequences.**

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The starting point value for an *Exercise & Hold ISO Shares* strategy is \$200,000, and your tax basis is \$100,000.

The starting point value for an *Exercise, Sell & Invest* strategy is \$165,000, calculated as follows:

FMV of ISO shares at exercise date	\$150,000
Tax basis (exercise price paid on exercise date)	\$100,000
Spread	\$50,000
Current FMV of ISO shares	\$200,000
FMV of ISO shares at exercise date	\$150,000
Appreciation	\$50,000
Current FMV of ISO shares	\$200,000
Less ordinary tax on the spread (at 35%)	(\$17,500)
Less short-term capital gains tax on appreciation (at 35%)	(\$17,500)
<b>Net proceeds</b>	<b>\$165,000</b>

Your timeframe for this scenario can be up to one year, assuming at least one year has passed since the grant date, depending on your exercise date. Here, since the ISO shares were held for six months, you would need to hold them for only six more months and one day to meet the required holding period.

Finally, assume a rate of return for your company stock and run a break-even analysis for the *Exercise & Hold ISO Shares* strategy and the *Exercise, Sell & Invest* strategy within your timeframe.

For this example we used a 5% appreciation in the stock price. You can calculate the required rate of return the alternative as follows:

Calculate future value for the *Exercise & Hold ISO Shares* strategy:

$$\$200,000 \times 1.05^{.5} = \$204,939$$

*Future value of your company shares at the end of the one-year total timeframe, assuming a 5% return rate*

$$\$204,939 - \$100,000 = \$104,939$$

*Built-in gain*

$$\$104,939 \times .20 = \$20,988$$

*Future tax at an assumed new long-term capital gains rate of 20%*

$$\$204,939 - \$20,988 = \$183,951$$

*Net proceeds*

Calculate future value for the *Exercise, Sell & Invest* strategy:

$$\$165,000 \times 1.3829^{.5} = \$196,585$$

*The alternative investment must grow at approximately 38.29% rate to reach a break-even point with the company stock. (You can calculate the required return by the using the Goal Seek function on a Microsoft Excel spreadsheet.)*

$$\$196,585 - \$165,000 = \$31,585$$

*Built-in gain*

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$\$31,585 \times .40 = \$12,634$

Future tax at an assumed new short-term capital gains rate of 40%

$\$196,585 - \$12,634 = \$183,951$

Net proceeds

Here is a table that compares the break-even points of both strategies at various rates of return for holding six months longer (to meet the requirement of holding for one year after exercise):

Company stock (ISOs) <i>Exercise and Hold</i>	0%	5%	10%	20%
Alternative investment <i>Exercise, Sell, and Invest</i>	30.30%	38.29%	46.08%	61.15%

When you step back and consider these results, you may quickly see that a disqualifying disposition is not a viable choice. This result may be intuitive: after all, you are considering paying taxes at current ordinary tax rates on the alternative investment rather than at a lower (albeit increased) future capital gains rate (within six months).

These results are specific to our assumed six-month timeframe and we did mention that the timeframe can be up to one year for this scenario. But if the timeframe is increased from six months to one year, the differential between the growth rates becomes narrower. Two factors drive this result: one is the alternative investment has more time to "catch up" to the company stock's performance, and the second is that the tax rate applied to the built-in gain on the alternative investment in Step (C) would be at the future long-term capital gains rate (assumed at 20%).

Here is a table that compares the break-even points of both strategies at various rates of return for a **one-year** timeframe:

Company stock (ISOs) <i>Exercise and Hold</i>	0%	5%	10%	20%
Alternative investment <i>Exercise, Sell, and Invest</i>	11.36%	17.42%	23.48%	35.61%

Regardless of the reduction in the gap, the alternative investment would still need to significantly outperform your company stock during the timeframe to make a disqualified disposition viable.

#### Third Scenario: Holding ISO Stock More Than One Year But Not Meeting The Two-Year Period From Grant Date

*You were granted 10,000 ISOs with an exercise price of \$10. You held the options for less than one year and then exercised them at \$15. The shares have been held for more than one year from the exercise date but you have not met the holding period of two years from the grant date. The shares are currently valued at \$20, the same price as at exercise. (This assumes no alternative minimum tax.)*

**Question:** Does a disqualifying disposition make sense in light of a likely increase in the capital gains tax rate?

The starting point value for an *Exercise & Hold ISO Shares* strategy is \$200,000. Your tax basis is \$150,000, based on the exercise price.

The starting point value for an *Exercise, Sell & Invest* strategy is \$175,000, calculated as follows:



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FMV of ISO shares at exercise date	\$150,000
Tax basis (exercise price paid on exercise date)	\$100,000
Spread for ordinary income	\$50,000
Current FMV of ISO shares	\$200,000
FMV of ISO shares at exercise date	\$150,000
Appreciation for capital gains	\$50,000
Current FMV of ISO shares	\$200,000
Less ordinary tax on the spread (at 35%)	(\$17,500)
Less short-term capital gains tax on appreciation (at 15%)	(\$7,500)
<b>Net proceeds</b>	<b>\$175,000</b>

Remember, according to the facts in this example, since you held the ISO shares for more than one year, the appreciation in value from the exercise date to the date of sale is subject to the long-term capital gains tax rate (currently 15%).

Your timeframe for this scenario could be as long as six months. As we mentioned above, this is an extremely rare case: to have it, you would need an ISO grant scheduled to vest and become exercisable in less than one year from the grant date, and you would need to exercise the options immediately upon vesting. Nonetheless, if you find yourself in this situation, you should apply the same analytical framework as illustrated in the Second Scenario.

Here is a table that compares the break-even points of both strategies at various rates of return for a six-month timeframe:

Company stock (ISOs) <i>Exercise and Hold</i>	0%	5%	10%	20%
Alternative investment <i>Exercise, Sell, and Invest</i>	3.57%	9.29%	15%	26.43%

The main difference between this scenario and the Second Scenario is subtle, namely the tax treatment on appreciation in your company stock from exercise date to sale date. However, the common thread between these two scenarios is the fact that the growth rate for the alternative investment would have to significantly outperform your company stock during the timeframe to make a disqualified disposition viable.

#### Fourth Scenario: Holding Unexercised ISOs

You are holding 10,000 ISOs with an exercise price of \$10. You have held the options for several years since grant date and they will expire within a year. The options have vested and are exercisable. Your company stock is currently trading at \$20.

**Question:** Does an immediate exercise and sale make sense in light of an increase in the capital gains tax rate?

Before you jump into this analysis, you need to determine if this is the right time to exercise your ISOs. We are assuming that these ISOs had a maximum opportunity to appreciate in value since we are now approaching expiration.

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The starting point value for an *Exercise & Hold ISO Shares* strategy is \$200,000. Your tax basis is \$100,000, based on the exercise price.

The starting point value for an *Exercise, Sell & Invest* strategy is \$165,000, calculated as follows:

FMV of ISO shares at exercise date	\$200,000
Tax basis (exercise price paid on exercise date)	\$100,000
Spread	\$100,000
Current FMV of ISO shares	\$200,000
FMV of ISO shares at exercise date	\$200,000
Appreciation	\$0
Current FMV of ISO shares	\$200,000
Less ordinary tax on the spread (at 35%)	(\$35,000)
Less short-term capital gains tax on appreciation (at 35%)	(\$0)
<b>Net proceeds</b>	<b>\$165,000</b>

**Note:** Since the exercise and sale take place on the same date in this scenario, you are dealing with only the spread, as there has not been any time for ISO shares to appreciate or decline in value. Also, to keep the comparison apples to apples, we assume that the ISO shares are first acquired through a full exercise and then the shares are sold. This causes the \$100,000 exercise cost to be included in the net proceeds from the sale of the shares. However, in practice, you would most likely implement a cashless exercise, leaving you with net proceeds of \$65,000.

Your timeframe is one year (the time it would take to meet the ISO required holding period).

Finally, assume a rate of return for your company stock and run a break-even analysis for the *Exercise, Sell & Invest* strategy and the *Exercise & Hold ISO Shares* strategy within your timeframe. This is the same analysis in the Second Scenario.

### AMT Adds More Complexity

Whether you are thinking about an ISO exercise with the intention of meeting the required holding period, or whether you are selling your ISO shares in a disqualifying disposition in the calendar year after the year of exercise, you must face the reality of the alternative minimum tax (AMT, explained in detail in other sections of myStockOptions.com). As more and more taxpayers fall within its grasp, those subject to the AMT must consider this drawback of holding ISO stock after exercise.

You know that at the exercise date the spread on the ISOs is not subject to ordinary income tax (assuming no disqualifying disposition). However, the spread must be treated as an addition to your alternative minimum taxable income during the year of exercise. This may immediately generate AMT (currently up to 28%). Therefore, you must evaluate the AMT impact and make the necessary adjustments (if any) to the number of ISOs you plan to exercise to avoid the AMT. If you generate an AMT upon the exercise of your ISOs, you will receive a minimum tax credit that will offset ordinary taxes in future years. Unfortunately, for those perpetually subject to the AMT, the planning for ISOs will be comparable to NQSO planning (where the spread at the exercise date will be immediately subject to taxes, but presumably at a lower tax rate, i.e. 28% AMT vs. 35% ordinary).

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**Evaluate the AMT impact and make the necessary adjustments.**

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### Conclusion

If the talk of a tax hike is pressuring you to do something with your ISOs, realize that you can receive the preferential tax treatment for your ISOs in just one year if the grant was made at least a year ago. This is because you either

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exercised your options or your options have vested and are currently exercisable. If this is not the case, you cannot do anything now: you must wait until your options vest.

Either way, don't let the prospect of a tax increase drive you to act rashly and cause you to deviate from your original objective of maximizing the tax benefits of your ISOs. Protect yourself by becoming familiar with the main factors in ISO planning and develop an analytical framework to assess your choices.

While the above scenarios are specific, they do provide a general framework for analyzing your situation. Simply substitute your variables such as the "spread" and the "appreciation from exercise date to sale date" and then crunch the numbers. In most cases, you will probably find that a disqualifying disposition will not be the best after-tax choice (unless you have other cash needs or you are concerned the stock price will fall). However, if you stay the course and choose the *Exercise & Hold ISO Shares* strategy, revisit your position when you have met the required holding period. That may be a good time to run a comparative analysis similar to the one in the First Scenario above.

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**Don't let a tax increase drive you to act rashly and cause you to deviate from your original objective of maximizing the tax benefits of ISOs. Develop an analytical way to assess your choices.**

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ISOs are even more complex than I first realized. When (or if!) my company's stock price goes up again, this analysis makes sense. I hadn't considered tax increases before now.

Written by: Jessica Reed on April 16, 2009

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