

Tax Ramifications of Stock Options

by Joseph Doerrer, CPA – January 17, 2020

After countless years of hard work, the valued employee earns an opportunity to become an owner of a company stock. Stock option grants can represent a tremendous wealth-building opportunity. Income taxes paid in connection with this event can amplify or erode the positive impact of this event on a client’s life. As a trusted adviser, it’s critical to have a firm grasp on the tax ramifications of the client’s actions in this situation.



Non-Qualified Stock Options

Non-qualified stock options (NQSOs) are one of two general classifications of stock options. NQSOs are the right to purchase shares of stock for a certain price during a specific time period. Typically, NQSOs are the right to purchase shares of stock for a certain price during a specific time period. Typically, upon grant of NQSOs, there is no income tax event. Once the options are exercised, ordinary income will be recognized for the discount between the fair value of the underlying stock and the exercise price of the options. This discount is known as the “bargain element.”

This income is also generally subject to federal payroll taxes (Medicare and Social Security) to the extent of any applicable limits. Any subsequent sale of the stock will be reported as a capital gain or loss. The basis of the stock, post-exercise, will be the exercise price plus the bargain element recognized in income. The example in the table below illustrates how the tax ramifications of this event play out.

Non-Qualified Stock Options 1 — Exercise & Sale Example

Exercise

Stock's Fair Value at Exercise

\$35.00

Exercise Price

Bargain Element/Income Recognized*	\$25.00
Sale	
Stock's Fair Value at Sale	\$50.00
Basis (Exercise Price + Bargain Element)	\$35.00
Capital Gain**	\$15.00

* Subject to ordinary income tax rates & federal payroll taxes

** Short or long-term character subject to holding period

Generally, after exercise, one can either sell the stock, hold the stock to capture appreciation, or some combination of the two. More advanced strategies include implementing a Section 83(b) or 83(i) election or gifting the NQSOs.

Incentive Stock Options

Like NQSOs, incentive stock options (ISOs) are the right to purchase shares of stock for a certain price during a specific time period. However, ISOs are eligible for preferential income tax treatment. To benefit from this treatment, one must be cognizant of additional rules not seen with NQSOs, like those surrounding employment of the option holder by the issuing company.

The following list highlights some of the rules set forth by Section 422 that must be complied with in order to receive the preferential ISO treatment upon exercise and subsequent disposition of the ISO shares:

- ISOs must be granted pursuant to a stockholder-approved plan. The grants must occur within 10 years of the date on which the plan was adopted or approved by stockholders, whichever is earlier. Such options may not be exercisable after the expiration of this 10-year period.
- The amount of value becoming exercisable for the first time in any calendar year cannot exceed \$100,000.
- A qualifying disposition (sale) of the ISO stock must take place more than two years after the grant date and more than one year after the exercise date. This is not all-inclusive. However, it provides good building blocks from which to gain comfort in dealing with ISOs.

This list is not all-inclusive. However, it provides good building blocks from which to gain comfort in dealing with ISOs.

Upon exercise of the ISO, there is no event for regular tax. There is a positive alternative minimum tax (AMT) income adjustment for the bargain element of the option. This amount is added to the stock's basis for AMT purposes.

Upon qualifying disposition of the shares, there will be a negative AMT income adjustment, versus regular tax, due to the increased stock basis for AMT purposes resulting from the additional income inclusion at exercise. The taxpayer will receive long-term capital gain or loss treatment on the disposal.

The example in the table below illustrates the tax implications of the exercise and qualifying disposition.

Incentive Stock Options — Exercise & Sale Example

Exercise	Regular Tax	Alternative Minimum Tax
Stock's Fair Value at Exercise	\$35.00	\$35.00
Exercise Price	\$10.00	\$10.00
Bargain Element/Income Recognized	\$-	\$25.00

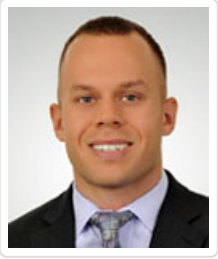
Qualifying Disposition	Regular Tax	Alternative Minimum Tax
Stock's Fair Value at Sale	\$50.00	\$50.00
Basis (Exercise Price + Bargain Element)	\$10.00	\$35.00
Long-Term Capital Gain	\$40.00	\$15.00

Where Section 422 is not complied with, the ISO will essentially revert to having NQSO status, along with the accompanying less-favorable tax treatment. Rather than deferring regular tax income upon exercise, and later being taxed on any appreciation above the exercise price at preferential capital gain rates, ordinary income must be recognized. The amount of income recognized will be equal to the fair market value of the options on the exercise date or the sale price, whichever is lower, less the exercise price. Where the disqualifying disposition occurs within the same year as the exercise, the AMT adjustment from the exercise is avoided.

There is some overlap between ISO and NQSO planning strategies in a general sense, in that strategies include selling or holding the underlying stock. However, additional planning considerations exist for ISOs, such as complying with Section 422, navigating the AMT adjustment upon exercise and managing any available AMT credit upon sale.

Understanding the tax ramifications of stock option transactions is critical. Before implementing any strategies, the client's financial situation should be assessed holistically. It's important to recognize that the best tax result isn't always the best financial result for your client. CPAs should, to the fullest extent possible, identify and plan for stock option

events before the time to make decisions is at hand. This will allow for the coordination between all interested parties (e.g., client, CPA, financial advisor) to ensure the best chance at implementing a winning plan.



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