INCENTIVE STOCK OPTIONS

STONEHEARTH CAPITAL MANAGEMENT

CONTENTS:

What are They? PAGE 1

How are They Taxed? PAGE 2

Planning Considerations PAGE 2

WHAT ARE THEY?

An incentive stock option (ISO) is a type of stock option that is granted to employees as part of an equity compensation plan offered by an employer. Employee stock option plans are used by companies as a type of employee benefit to provide an opportunity for employees to own shares in the company. Incentive stock options are a specific type of employee stock option that qualify for special tax treatment when a certain set of conditions are met, as described below. An ISO provides the employee with the option to buy a specified number of their company's shares at a certain price during a specified time period.

There are a few key terms used with ISOs to define how a company's specific stock option plan has been designed.

- **Grant** – When a company issues ISOs to an employee, this is referred to as a Grant and the specific date that the options are granted is referred to as the Grant Date.
- **Exercise Price** – Also referred to as the Strike Price. This is the price that an employee would pay to purchase the company shares of stock. This price must be equal to the fair market value of the company's stock on the Grant Date.
- **Vesting Period** – The period after the Grant Date that an employee must wait to exercise their options. Vesting is defined separately for each grant with a vesting schedule. For example, a grant of 1,000 NQSOs may have a four-year vesting schedule with 25% of the options vesting each year.
- **Exercise Date** – The date that an employee elects to exercise their ISOs. Exercising a stock option refers to purchasing the company's stock at the exercise price set at the grant. This date defines the starting point for their ownership of the stock.
- **Expiration Date** – The last date than an employee can exercise a stock option. All stock options have an expiration date, typically 10 years after the grant date. Note that certain events, such as termination or retirement, may accelerate expiration.

HOW ARE THEY TAXED?

The taxation of incentive stock options can be complex, and consideration should be given to the tax rules when you own ISOs. As mentioned above, ISOs can receive preferential tax treatment for the employee once the shares are sold. The tax treatment depends on how long the stock is held after the exercise date.

Specifically, long-term capital gains can apply to the sale of a stock acquired via an exercise of an ISO, provided that the shares are held for:

- Two years from the grant date, AND
- At least one year after the exercise date

There is no taxation to the employee upon the grant or vesting of ISOs. Instead, tax is deferred until the employee sells the stock.

The strike price (exercise price), which is the price that the employee paid to purchase the shares, becomes the tax basis in the stock.

Upon sale of the stock, any gain is treated as long-term capital gain, provided that the holding period requirements mentioned above, are met. If shares are sold prior to meeting either of the two holding period provisions, referred to as a disqualifying disposition, the sale will be subject to ordinary income taxation.

An important tax consideration with ISOs is the potential application of the alternative minimum tax (AMT). Specifically, the difference between the fair market value of the stock at the time of exercise and the option exercise price factors into AMT income for the year of exercise and may expose an individual to the alternative minimum tax.

PLANNING CONSIDERATIONS

Incentive Stock Options can provide substantial economic gain; however it is important to develop a plan to leverage the maximum benefit from ISOs. It is common for employees who participate in an ISO plan to receive multiple grants, sometimes in consecutive years, resulting in hundreds or sometimes thousands of options with various grant dates, vesting periods, and expiration dates. It is important to be aware of the specific provisions on your company's ISO Plan. For example, you will want to be aware of what happens to your vested and unvested options if you were to leave your company, or if your company is acquired by another company.

As outlined above, taxes play an important role in how you can best leverage the value of your ISOs. Consideration should be given to the potential exposure to the alternative minimum tax when you are planning to exercise.

You will also want to be aware of your liquidity needs since the holding period requirements to receive favorable tax treatment means that you will be holding your shares for at least a year after you have purchased them, meaning that you will have an expense without the immediate recovery of assets from selling the shares.

Another consideration to be aware of is concentration risk, which can arise from an increase in the amount of company shares you own from exercising stock options. Advanced planning should be done to develop an optimal amount of company shares that you own as a percentage of your overall portfolio.

Finally, you will want to develop any planning around your employee stock options within the context of your overall financial plan. There is no one-size-fits-all game plan with ISOs, so it's important to consider all of your financial goals when developing a plan to maximize your employee stock options.

CONTACT US

Stonehearth Capital Management
199 Rosewood Drive, Suite 200
Danvers, MA 01923

978.624.3000

info@stonehearthcapital.com
www.stonehearthcapital.com