

ZajacGROUP

The Ultimate Guide to Incentive Stock Options

Including a Detailed Analysis of How You May be Impacted
by Income Tax & Investment Performance

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About Daniel Zajac, CFP®, EA, CLU®



About Daniel Zajac, CFP®, EA, CLU® As an award-winning writer, speaker, financial advisor, and Zajac Group managing partner, Daniel Zajac, CFP®, EA, CLU® is dedicated to educating the community about employee stock options, restricted units, and other forms of equity compensation planning. Whether his audience includes company founders, Section 16 officers, financial colleagues, employees, retirees, or others, Daniel believes anyone can learn how to make informed decisions about equity compensation. He loves bringing clarity to conversations about both pre-IPO and publicly traded forms of equity compensation.

Daniel became a financial advisor in 2004. In 2020, he teamed up with family members to form Zajac Group, where he became managing partner in 2022. When some of Daniel's earliest financial planning clients needed help managing their equity compensation, he soon discovered a knack and a need for offering practical experience and plain-spoken advice on the subject to business owners and employees alike. He has been helping families ever since as they decide when and how to vest, exercise, hold, sell, and pay taxes on equity grants, while aligning their stock options and other equity compensation with their greater financial plans.

Daniel has been a CERTIFIED FINANCIAL PLANNER™ professional since 2007. He is also a Chartered Life Underwriter® (CLU®) and an IRS Enrolled Agent (EA). He holds a bachelor's degree in business administration with an emphasis in finance from Drexel University.

A lifelong teacher and student at heart, Daniel is licensed to provide continuing education (CE) learning for CFP® practitioners. He also has presented at Financial Planning Association events held nationwide, consulted with E-Trade (since acquired), and appears regularly on MyStockOptions.com. Supplementing his own blog on equity compensation, Daniel's articles, insights, and commentary are frequently cited in a variety of national financial forums and news outlets, including Forbes, Barron's, Kiplinger, CNBC, and Kitces.com.

Outside of work, Daniel is a devoted father, husband, Ironman athlete, reformed soccer player, and multiple marathon finisher. "I have the honor of doing what I love, surrounded by people I love," says Daniel. "I'm most energized when I am able to help others find the time and financial freedom to do the same."

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Introduction



If you have stock options, then you have the ability to access an asset that provides you with a choice. Very literally, a stock option is an option; it's a form of compensation that gives you the right (but not the obligation) to buy shares of company stock at a set price at some time in the future.

Acting on this choice is known as exercising your stock options. To decide whether or not you want to exercise your options, you might want to look at the current stock price.

If the current stock price is below the price at which you can exercise, your option is underwater or “out-of-the-money.” There may not be much point in exercising here. If the fair market value of the share is higher than the price at which you could exercise, however, the option is “in-the-money” and it may make sense to exercise.

But before you do, you may want to understand that exercising your options is a taxable event.

When exercised, the spread between the price at which you were granted the option and the share's fair market value is one of the major factors that determine your tax liability, but it's far from the only thing you need to consider.

Another key factor is what kind of option you have: incentive stock options, or non-qualified stock options. From there, you may have to think through holding periods, the alternative minimum tax, how handling your options impacts your own cash flow, your investment risk tolerance, what your end goals are... and so on.

Understanding exactly what you'll owe come tax time is never straightforward, and stock options only further complicate the picture. So, let's take a deep dive into this issue today and specifically look at incentive stock options.

What is an Incentive Stock Option?

Here's what you need to understand if you want to build a sound strategy to better manage and make the most of your incentive stock options.

An incentive stock option is a particular type of employee compensation that can only be offered to a company's employees up to certain amounts (as opposed to non-qualified stock options, which can be awarded to employees, consultants, advisors, and other non-employees).

You might hear these referred to as statutory stock options, as well. Either way, incentive stock options, or ISOs, can be a highly desirable form of equity comp for many reasons — including the fact that they may be taxed at lower rates than other forms of options or grants of company shares.

Lower tax rates mean that you may be able to pay long-term capital gains tax rates on realized gains from the original exercise price to the final sales price. Long-term capital gains tax rates are attractive because they are usually lower than short-term capital gains rates and ordinary income rates.

But to obtain this preferential tax treatment, you'll need to achieve a qualifying disposition for your ISOs.

A qualifying disposition requires that you meet two special holding period rules:

- 1. The final sale of the stock must occur at least 2 years from the grant date of the stock option, AND**
- 2. The final sale of the stock must occur at least 1 year from the exercise date of the stock.**

Anything that does not meet these rules is known as a disqualifying disposition and won't qualify for long-term capital gains. Instead, realized gain from a disqualifying disposition will often be taxed as ordinary income and short-term capital gains.

While the idea of paying long-term capital gains tax rates (as compared to ordinary income) looks appealing, managing your ISOs isn't always that straightforward. When you exercise and hold your shares to meet the 1-year hold requirement, you also need to look at the impact of paying the alternative minimum tax.

The Alternative Minimum Tax on ISOs

The alternative minimum tax, or AMT, may be applied to the spread between the exercise price of an incentive stock option (ISO) and the share's fair market value at exercise. This spread is known as the bargain element. AMT acts a bit like a prepayment of the tax due on the final proceeds of your ISOs.

AMT is based on parallel tax system to the regular federal income tax system. This means you need to calculate your income tax twice every year: once under the regular tax rules, and a second time under the rules that apply to AMT. After you run the numbers and compare them, your tax due is the higher of the two.

To calculate AMT, you first need to calculate your Alternative Minimum Taxable Income (AMTI). AMTI adds back certain deductions and adjustments into your taxable income, and many of deductions you might enjoy on regular federal taxes do not apply here.

AMTI also includes the bargain element (which is the difference between the exercise price of your stock option and the fair market value at exercise, multiplied by the number of shares purchased) of exercising your ISOs as income.

For comparison, the bargain element is not counted when figuring your regular income if you exercise and hold the shares. The result of its inclusion in AMTI means exercising ISOs may inflate your AMT in the year you exercise your incentive stock options.

Once your AMTI is calculated, then the exemption is applied to find your Alternative Minimum Tax Base:

$$\text{Alternative Minimum Tax Base} = \text{Alternative Minimum Tax Income} - \text{Exemption}$$

AMTI is taxed at a flat 26% and 28%. If your AMTI is below the 26%/28% dividing line, you'll be taxed at a flat 26% rate. If AMTI is over the dividing line, then the portion of your income below the dividing line is taxed at 26% and the remainder is taxed at 28%.

This leads to the tentative minimum tax. If your tentative minimum tax is below your regular tax, you will not owe AMT. If your tentative minimum tax is higher than the regular tax, you will owe AMT. The AMT you actually pay is the difference between your regular tax and your tentative minimum tax, when the tentative minimum tax is the higher of the two.

■ The Impact of AMT on Qualifying Dispositions Versus Disqualifying Dispositions

If you have incentive stock options (ISOs), you may or may not be subject to the AMT. ISOs are taxed differently based on whether or not you do a qualifying or disqualifying disposition, as well as the timing of your transactions.

As a result, you may incur the following types of taxes after you exercise your options:

1. Compensation Income: Taxed as ordinary income
2. Capital Gains: Subject to short-term and long-term capital gains rates
3. Net Investment Income Tax (NIIT): A supplemental tax of 3.8% on capital gain assets in excess of certain amounts
4. Alternative Minimum Tax (AMT): Subject to a second set of tax calculations, typically taxed at 26% or 28%

If you do a disqualifying disposition of your ISOs, the realized gain between the exercise price of the stock option and the fair market value at exercise is generally taxed as compensation income (not subject to payroll tax, nor is income tax withheld).

If the final sale of the stock occurs in the same calendar year of the exercise, you will not be subject to AMT. If the final sale occurs in the year following the year of exercise, you will need to report the bargain element as a tax preference item for the calendar year you exercised and held.

This means that even with a disqualifying disposition, you may be subject to AMT. It all depends on the timing of your transactions.

If you do a qualifying disposition, on the other hand, the bargain element is a tax preference item when figuring the AMT for the calendar year you exercise. You're then subject to the corresponding AMT taxes that may be triggered by this.

When you sell your ISO shares in a final sale, you pay long-term capital gains rates on the realized gains from the original exercise price to the final sales price.

If you follow the above scenario, you might think it looks like you paid taxes on the bargain element portion of the transaction twice: the first time via the AMT in the year you exercised and held, and the second when you sold your shares in a final sale as long-term capital gain. So, we need to talk about the AMT credit.

■ How the AMT Credit Impacts Your ISOs

When you sell your incentive stock option (ISO) shares in a final sale, the alternative minimum tax (AMT) credit may allow you to recover some or all of the prepayment of AMT.

The credit is partially figured by a tax calculation that refigures your capital gains using a dual basis: one basis for capital gains shares for your regular tax rate, and one basis for those same shares for your tentative minimum tax. Generally speaking, the spread between your regular capital gains and your capital gains as refigured for AMT may be used as a negative adjustment when figuring your AMTI. A negative adjustment to your AMTI may lead to a lower alternative minimum tax base and a lower tentative minimum tax.

If you've previously paid AMT due to ISOs, and have a tentative minimum tax that is lower than your regular tax, the difference the two may be eligible to come back to you as an AMT credit.

And if you previously paid AMT from ISOs you exercised that weren't eligible for the credit in one year, you can carry that forward to potentially use in future years. Carryforward AMT credit is common, as the AMT credit may not fully refunded in the calendar year following the year you sell the stock (when you file your tax return).

■ The Timing of When You Pay Taxes Due and Other Cash Flow Considerations

In addition to understanding what type of tax you may owe depending on whether you have a qualifying or disqualifying disposition, you should consider when you'll owe those taxes.

Generally, taxes are due on the normal tax date of April 15th (or the specific date for that calendar year if the 15th falls on a weekend or holiday). This will happen in the year following the year of your transaction if taxes owed are compensation income due to a disqualifying disposition or AMT due to an exercise and hold.

Similarly, when you sell your shares in a final sale, long-term capital gains, net investment income tax (NIIT), and AMT credits are not due (or credited) until April 15th in the following year. And while you might not need to pay your tax bill until April 15th of the following calendar year, it's possible you'll need to make estimated tax payments in the year of the transaction.

This may be an option if you want to do some cash flow planning, or it might be required due to the IRS' penalties for underwithholding. This is true regardless of when you actually exercise and/or sell your options/shares during the calendar year.

Your cash flow can be impacted by taxes owed as well as the exercise and sale of shares themselves. For example, when you exercise and hold your stock options, you may need to pay cash to cover the cost of the exercise.

When you sell your shares, you will receive the cash proceeds and should plan to properly manage that cash. Generally speaking, you may be able to time these cash flows to occur any time during the calendar year, from January 1 to December 31.

The chart below can help illustrate the timing of when your cash flow might feel the effects of your decisions with ISOs; the red text represents a negative cash flow event:

	Qualifying Disposition	Disqualifying Disposition
Cost of Shares	Due at the time of exercise	Due at the time of exercise, unless sold via a cashless exercise
AMT	Due by April 15th in the year following the year of exercise and hold	Due by April 15th in the year following the year of exercise (if you exercise and hold past the calendar year end)
Compensation Income Tax	N/A	Due by April 15th in the year following the year of exercise and sell
Long-Term Capital Gains Tax	Due by April 15th in the year following the year the final sale	Due by April 15th in the year following the year the final sale
Net Investment Income Tax (NIIT)	Due by April 15th in the year following the year the final sale	Due by April 15th in the year following the year the final sale
Sale Proceeds	Received in full in the year of final sale	Received in full in the year of final sale
AMT Credit	Credited in the year following the year of final sale	N/A

Running the Numbers: Scenarios to Compare Disposition Types for Your ISOs



Many people feel tempted to make achieving a qualifying disposition the primary objective of their stock option management strategy. But the possible value created by receiving a long-term capital gains tax treatment may not always be your best bet when you run the numbers.

The best course of action is likely subject to your gross income, the bargain element, and the type of disposition that is best for your entire financial situation. These factors impact how much you will pay in various taxes, how much you receive in after-tax proceeds, and when you get those funds.

That doesn't even touch on what might be the most important factor in your entire decision-making process: the potential volatility of the stock during the one-year holding period requirement for a qualifying disposition, and how that investment risk could affect your overall financial plan.

We can look at a few different scenarios to see how this plays out with real numbers.

■ Qualifying Dispositions May Look Appealing from a Tax Viewpoint

We'll start with a simple cash flow analysis that uses some basic assumptions. Let's say we have a hypothetical 50-year-old couple, making \$250,000 per year, married filing jointly, using a standard deduction, with the following ISO grant:

- Grant Date: January 1, 2020
- Exercise Price: \$1.00
- ISO Shares: 10,000
- Current FMV: \$26.00
- Final Sale Price: \$26.00

We'll also use the following tax rates:

- Long-Term Capital Gains: 15%
- Ordinary Income Tax: 24%
- Alternative Minimum Tax: 26%

With our assumptions in place, we want to look at the outcomes of two scenarios. One will show a qualifying disposition where the couple exercises and sells their shares from their incentive stock options (ISOs) as soon as possible to qualify. The other shows a disqualifying disposition, where they exercise and sell ISO shares as soon as possible.

With this information, we can calculate the expected costs and expected proceeds for individual parts of the transaction. These calculations can then be used to model projected cash flows and profitability of a qualifying and a disqualifying disposition.

They include, and are calculated as:

- ▼ Negative Cash Flows:
 - ▼ Cost of the Shares = ISO Shares Exercised x Exercise Price
 - ▼ AMT = AMT Tax Rate x Bargain Element
 - ▼ Bargain Element = FMV at Exercise – Exercise Price
 - ▼ Long-term Capital Gains Tax = LTCG Rate x (Final Sale Price – Exercise Price)
 - ▼ Net Investment Income Tax = 3.8% x Long-Term Capital Gain
 - ▼ Compensation Income Tax = Ordinary Income Tax Rate X Bargain Element
- ▼ Positive Cash Flows:
 - ▼ Final Sale Proceeds = Final Sale Price x ISO Shares
 - ▼ AMT Credit = AMT Tax Rate X Bargain Element

We can illustrate the cash flows in a simple chart that compares the after-tax proceeds of a qualifying disposition and disqualifying disposition:



In this example, we could reasonably suggest that a qualifying disposition is the preferred outcome, as the “total value” is \$13,000, or approximately 6.8% higher, than the disqualifying disposition alternative.

Digging further into the details, we should identify several important notes with regards to the analysis:

1. The AMT credit is unique in that it is possible only a portion of an AMT credit will be refunded in the year you sell your ISO shares as qualifying disposition. The remainder will be carried forward to a future year. For our illustration, we have assumed 70% will be refunded and 30% will be carried forward. It goes without saying that personal tax projection should be considered to see how your return will be impacted.
2. On the qualifying disposition side of the ledger, we have included NIIT. NIIT is an additional tax of 3.8% that you may incur on realized capital gain assets when your income exceeds certain levels. In our example, it increases the tax rate on long-term capital gains from 15% to 18.8%. The net result of an additional 3.8% on capital gains is a reduction in the potential tax spread that you may gain between ordinary income and long-term capital gains rates, and a reduction of the perceived benefit of a qualifying disposition.



How Income Levels Impact Tax of a Qualifying and Disqualifying Disposition

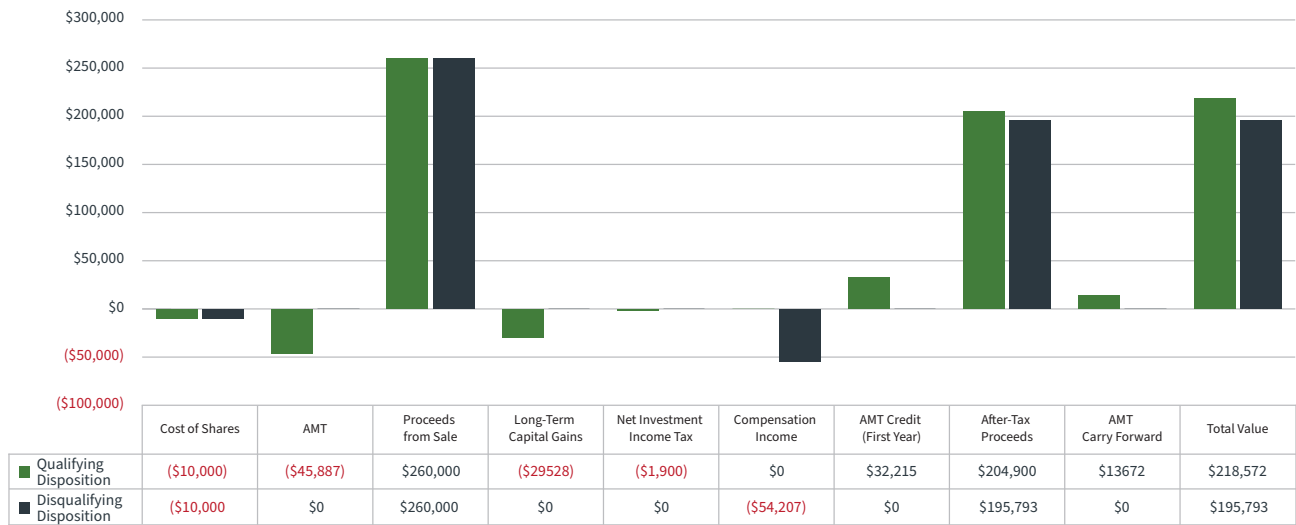
Unfortunately, the simple example above does not fairly represent the nuance of incentive stock options (ISOs). To get a more accurate understanding, we should test the above illustration using actual 2020 tax law and several different income levels.

You'll see that at different income levels, the amount you pay in ordinary income tax, AMT, and NIIT changes. Your income level may also impact how quickly you receive the AMT credit.

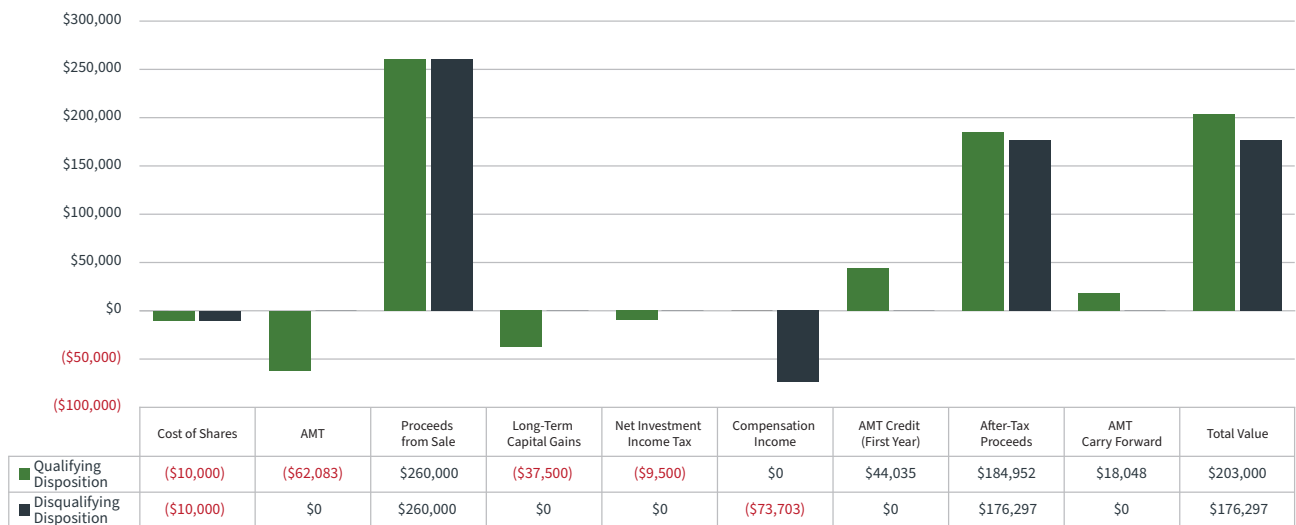
Let's look at a few different levels to see this in action. We'll use gross incomes of \$50,000 (as our “low income” example), \$250,000 (for a “middle” income), and \$500,000 (to represent a “high” income).

Following our charts from above and figuring actual tax calculations, we see the following:

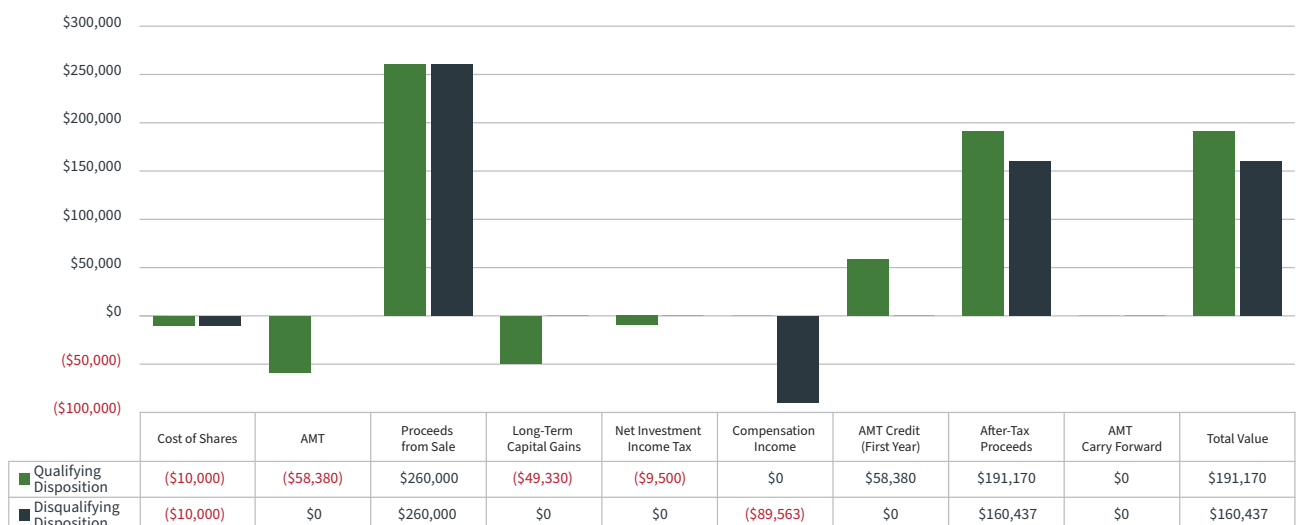
Low Income: \$50,000



Middle Income: \$250,000



High Income: \$500,000

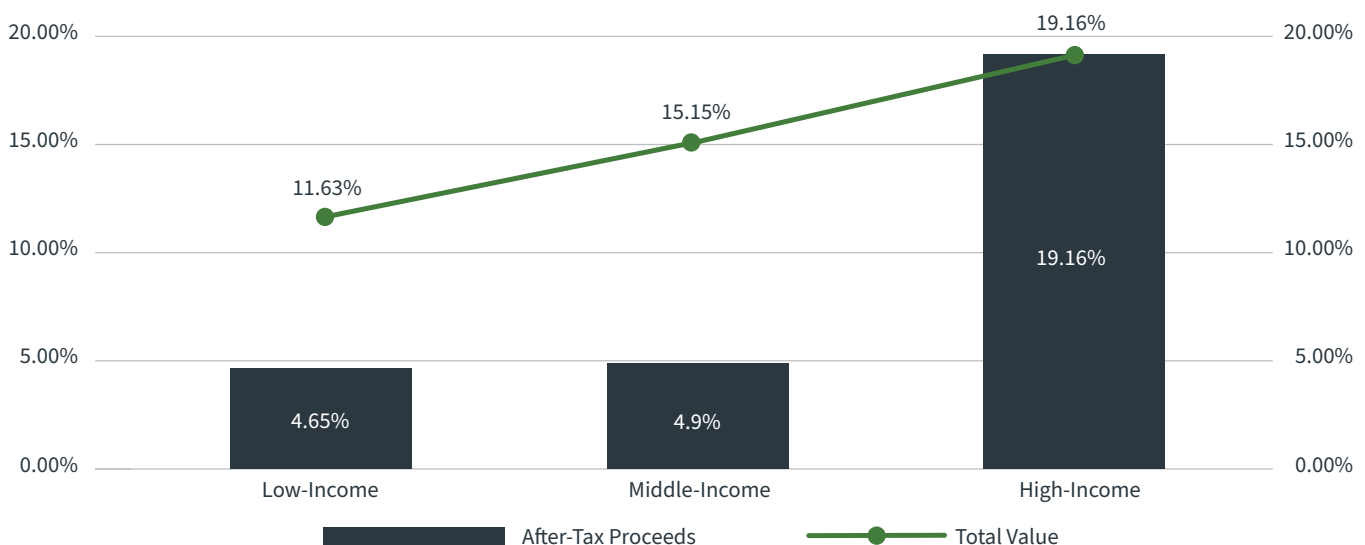


A few interesting points of note from the charts:

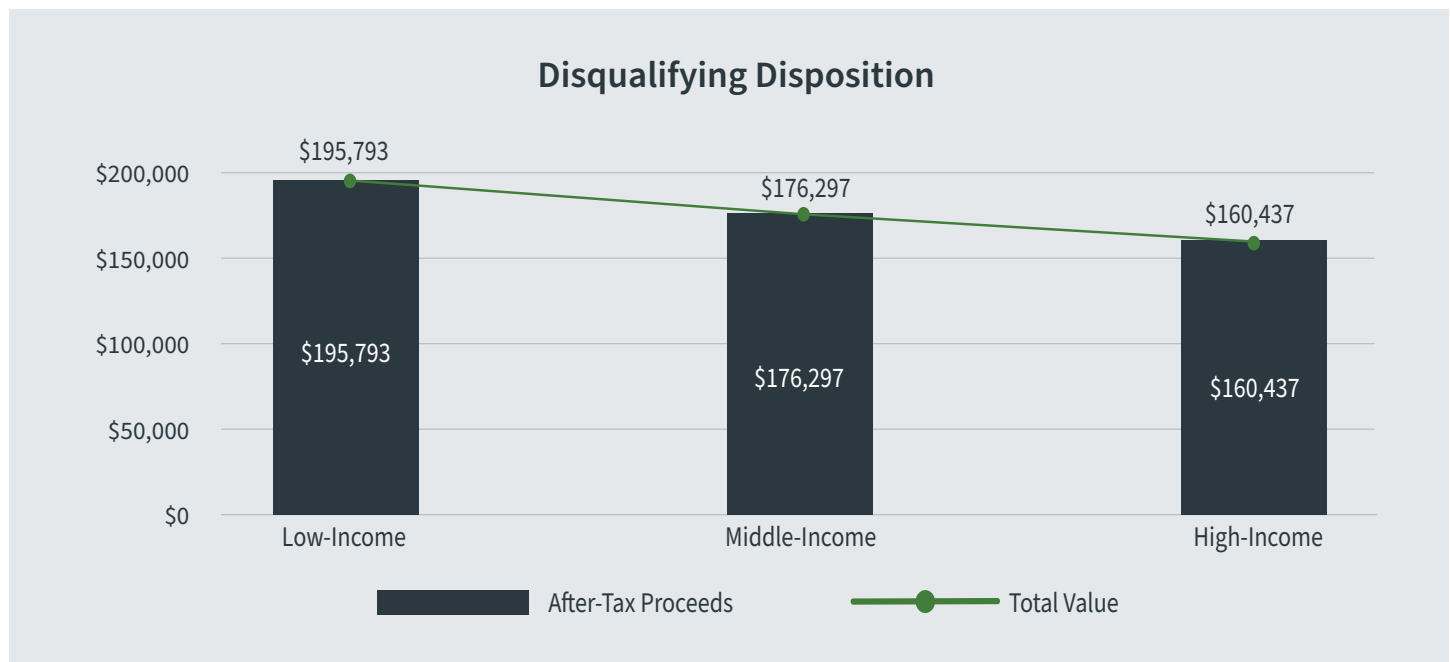
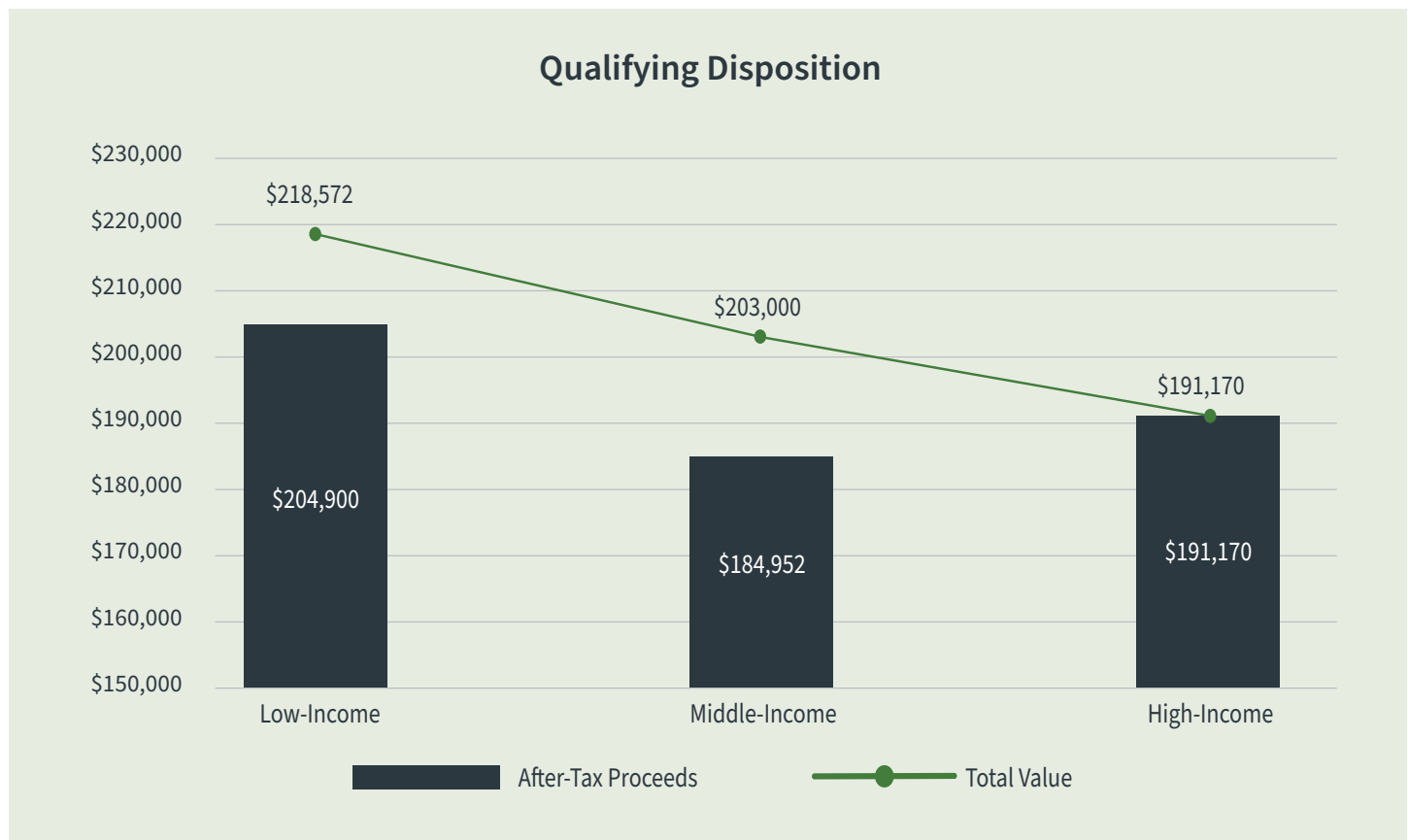
- ▼ Long-term capital gains tax for each transaction are materially different. This is a function of the 0%, 15% and 20% tax brackets for long-term capital gains. In the low-income scenario, some of the gain is taxed at 0% and the remainder at 15%. In the middle-income scenario, the full amount is taxed at 15%. In the highest income example, most of the LTCG is taxed as 20%, with a small portion at 15%.
- ▼ This example shows that you will pay more in AMT in the middle-income scenario than you will in the high-income scenario. This is a result of how the regular tax and tentative minimum tax are calculated. In this middle-income range, the percentage spread between the effective regular tax rate and the effective tentative minimum tax is smaller than the spread between the two in the low- and high-income scenarios. A smaller spread in the average tax rates means a greater likelihood of AMT.
- ▼ In the low-income scenario and the middle-income scenario, only a portion of the AMT is returned as a credit in the year of sale. For the low-income scenario, this is partially a result of a 0% LTCG rate. In the middle-income scenario, this is a result of the smaller percentage spread between the average regular tax rate and the average tentative minimum tax rate.
- ▼ As your gross income increases, so to do the likelihood of paying additional NIIT on your LTCGs.

To confirm the potential benefit of a qualifying disposition, we can compare the after-tax proceeds and total value at each income level.

Using percentages to quantify the benefit of a qualifying disposition, we see the following:



We can also quantify by comparing cash values:



This provides us with a few more takeaways:

- ▼ When the total value scenarios are reviewed, the low-income group benefits the least from a qualifying disposition and the high-income group benefits the most. This suggests that a qualifying disposition may be most attractive to higher income earners.
- ▼ This benefit is driven by a spread between the ordinary income tax rate and the long-term capital gain tax rate that is larger in the high-income tax brackets than the spread in the middle- and low-income tax bracket. A larger spread means a greater potential tax benefit of a qualifying disposition.
- ▼ The after-tax value created by a qualifying disposition for low- and middle-income levels, as a percentage of the total value, is low. In the short term, there is less benefit to this strategy than there is in the long-term. The longer-term potential benefit is tied to your receipt of the AMT carryforward credit.
- ▼ In the high-income example, the after-tax proceeds and the total value are identical. This means that the full value of the qualifying disposition is received the ISO shares are sold, as the full AMT credit is refunded in the year following the sale (in this example – it's possible that this may not always be the case in the high-income scenario). As it relates to cash flow, the financial benefit of a qualifying disposition may be greater for a high-income earner as compared to a low-income earner.

▼ Do Qualifying Dispositions Expose You to More Investment Risk?

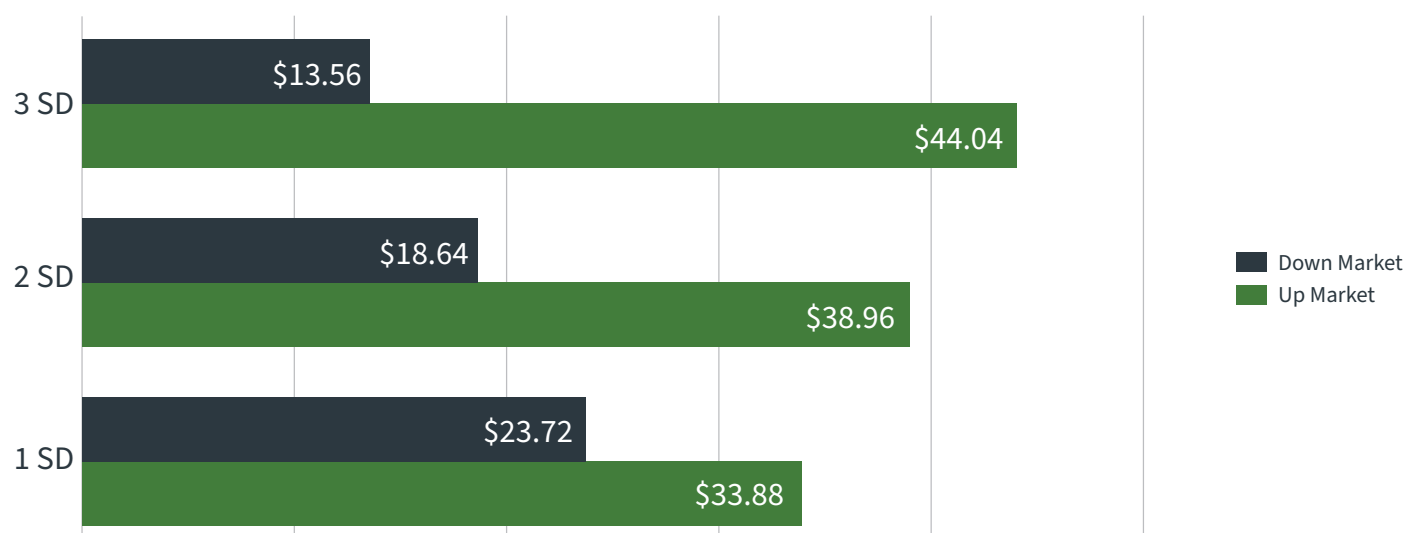
The tax benefit of a qualifying disposition can be an attractive driver in planning a strategy for your ISOs. But to capture this tax alpha, you'll need to hold the stock for at least one-year post-exercise.

That means taking on concentration risk, and in all likelihood, seeing the stock price fluctuate during this time period. An appreciating stock price likely means a higher sale price and a higher after-tax value. But a falling stock price might lead to a lower sales price and an after-tax value below any perceived tax benefit that you were seeking to obtain, leaving you wishing you had simply sold the stock as soon as possible.

To illustrate potential stock volatility and investment risk of a qualifying disposition, we can use a single stock to illustrate future stock prices. Below, we'll use hypothetical stock "X" as our proxy.

Let's assume that hypothetical stock "X" had an average rate of return of 10.78% and a standard deviation of 19.54. If we apply the mean rate of return and standard deviation to our arbitrary \$26.00 per share price, we can calculate what the future one-year price target as one, two, and three standard deviations may be:

Current Stock Price: \$26/Share



With a projected stock price in place, we can update the ISOs cash flow charts and calculate the future values. We will use the middle-income scenario, with average tax rates equal to the calculated average tax rates in our middle-income scenario above.

Assuming a qualifying disposition, we see the following:

Qualifying Disposition – “X”	\$13.56	\$18.64	\$23.72	\$26.00	\$33.88	\$38.96	\$44.04
Cost of Shares	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)
AMT	(\$62,083)	(\$62,083)	(\$62,083)	(\$62,083)	(\$62,083)	(\$62,083)	(\$62,083)
Proceeds from Sale	\$135,616	\$186,420	\$237,224	\$260,000	\$338,832	\$389,636	\$440,440
Actual LTCG Tax	(\$18,842)	(\$26,463)	(\$34,084)	(\$37,500)	(\$49,325)	(\$56,945)	(\$64,566)
NIIT	(\$4,773)	(\$6,704)	(\$8,635)	(\$9,500)	(\$12,496)	(\$14,426)	(\$16,357)
AMT Credit (First) Year	\$44,035	\$44,035	\$44,035	\$44,035	\$44,035	\$44,035	\$44,035
After-Tax Proceeds	\$83,953	\$125,206	\$166,459	\$184,952	\$248,964	\$290,217	\$331,470
AMT Carry Forward	\$18,047	\$18,047	\$18,047	\$18,048	\$18,047	\$18,047	\$18,047
After-Tax Value	\$102,000	\$143,253	\$184,506	\$203,000	\$267,012	\$308,264	\$349,517
Percentage Change	-49.75%	-29.43%	-9.11%	0.00	31.53%	51.85%	74.18%

There is significant dispersion in the after-tax value range of outcomes. To capture the tax alpha of a qualifying disposition, then, you'd have to accept the possibility of a 49.75% reduction in your after-tax value. On the positive side, you see a potential after-tax value increase of 74.18%.

To help decide if this risk/reward to capture tax alpha is “worth it,” it makes sense to compare a qualifying disposition to that of a disqualifying disposition.

Let's assume you exercise and sell shares immediately for a disqualifying disposition. You then take the proceeds and reinvest them into the same “X” stock. (Yes, this is an unlikely move in reality — but it will help illustrate what we want to investigate, which is the tax impact of the disposition types.)

With the identical future projected stock projections, we can illustrate the future after-tax values using a cash flow chart. Since we are assuming a disqualifying disposition, the tax implications change and the chart should be updated accordingly.

Specifically, we'll update the following:

- ▼ If you exercise and sell on the same day (as we will use for our assumption), you will pay ordinary income tax rates on the bargain element.
- ▼ The full value of the proceeds of the exercise and sell will be invested. Any future gain/loss will be subject to long-term capital gains (loss) and NIIT rates. For simplicity, we have valued the capital loss a positive offset at long-term capital gains rates.

Disqualifying Disposition	\$13.56	\$18.64	\$23.72	\$26.00	\$33.88	\$38.96	\$44.04
Cost of Shares	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)
Proceeds from Sale	\$135,616	\$186,420	\$237,224	\$260,000	\$338,832	\$389,636	\$440,440
Gain/Loss	(\$124,384)	(\$73,580)	(\$22,776)	\$0	\$78,832	\$129,636	\$180,440
Long-Term Capital Gains	\$0	\$0	\$0	\$0	(\$11,825)	(\$19,445)	(\$27,066)
Net Investment Income Tax	\$0	\$0	\$0	\$0	(\$2,996)	(\$4,926)	(\$6,857)
Compensation Income	(\$73,703)	(\$73,703)	(\$73,703)	(\$73,703)	(\$73,703)	(\$73,703)	(\$73,703)
Value of Capital Loss	\$23,384	\$13,833	\$4,282	\$0	\$0	\$0	\$0
After-Tax Value	\$75,298	\$116,551	\$157,803	\$176,297	\$240,309	\$281,562	\$322,815
Percentage Change	-57.29%	-33.89%	-10.49%	0.00%	36.31%	59.71%	83.11%

The dispersion in the after-tax values is similar to the qualifying disposition scenario, as you would expect using the same rate of return and standard deviation assumptions.

What might not be as obvious is a comparison of the after-tax values:

	\$13.56	\$18.64	\$23.72	\$26.00	\$33.88	\$38.96	\$44.04
Qualifying Disposition	\$102,000	\$143,253	\$184,506	\$203,000	\$267,012	\$308,264	\$349,517
Disqualifying Disposition	\$75,298	\$116,551	\$157,803	\$176,297	\$240,309	\$281,562	\$322,815
Dollar Difference	\$26,703	\$26,703	\$26,703	\$26,703	\$26,703	\$26,703	\$26,703

The after-tax value of the qualifying disposition is higher at every sample standard deviation than that of the disqualifying disposition. The largest tax benefit as a percentage of value is realized at the 3-standard deviation down market scenario.

A larger after-tax value across the table might help make an argument that all else being equal, a qualifying disposition is preferred to a disqualifying disposition in any market with the same performance metrics. This tax buffer provided in the down-market scenarios is a function of how both disposition types are taxed for ordinary income tax rates and long-term capital gain tax rates.

In a disqualifying disposition that occurs via an exercise and immediate sell, ordinary income is “locked in” on the spread between the exercise price and the fair market value at exercise. If the market drops after the exercise and sell, capital losses may be used to offset future capital gains and/or ordinary income.

For our purposes and for this illustration, we have assumed the capital loss will be used to offset future long-term capital gains.

In the qualifying scenario, long-term capital gains are reported on the spread between the exercise price of the ISO and the final sale price (assuming it is the higher of the two). If you sell your ISO shares at a final sales price that is lower than the price as which you exercised, you will pay capital gains on the spread between the exercise price and the final sales price.

Previously paid AMT may be refunded against other ordinary income if your regular tax return calculations allows for it. In our example, we show this refund, which leads to the tax buffer.

In the example, we can also see that \$26,703 — the spread in each scenario — is equal to the simplified chart above. If we were to calculate the models for low and high incomes (which wasn’t illustrated here), the results also equal the spread in the charts above.

This continues to suggest that the low-income scenario benefits the least and the high-income benefits the most from a qualifying disposition of incentive stock options. This is a result of the spread between the effective regular tax rates and the effective tentative minimum tax rates.

Comparing Investment in a Single Stock to Investing Proceeds from Disqualifying Dispositions in a Diversified Portfolio

Again, it's unlikely that if you secure a disqualifying disposition of ISOs that you would turn around and reinvest the proceeds into the same stock. You would most likely consider reinvestment into a diversified portfolio.

Adding an alternative allocation to the conversation, let's assume that you reinvest the proceeds of a disqualifying disposition into a more diversified allocation, "Y" with the following metrics

- ▼ Mean Return: 6.12%
- ▼ Standard Deviation: 14.53%

Assuming the current market price of \$26.00 per share, a one-year price target for the "Y" may be:



Following the same logic as above, we see the chart on the following page.

Disqualifying Disposition – “Y”	\$16.26	\$20.04	\$23.81	\$26.00	\$31.37	\$35.15	38.92
Cost of Shares	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)	(\$10,000)
Proceeds from Sale	\$162,578	\$200,356	\$238,134	\$260,000	\$313,690	\$351,468	\$389,246
Gain/Loss	(\$97,422)	(\$59,644)	(\$21,866)	\$0	\$53,690	\$91,468	\$129,246
Long-Term Capital Gains	\$0	\$0	\$0	\$0	(\$8,054)	(\$13,720)	(\$19,387)
Net Investment Income Tax	\$0	\$0	\$0	\$0	(\$2,040)	(\$3,476)	(\$4,911)
Compensation Income	(\$73,703)	(\$73,703)	(\$73,703)	(\$73,703)	(\$73,703)	(\$73,703)	(\$73,703)
Value of Capital	\$18,315	\$11,213	\$4,111	\$0	\$0	\$0	\$0
After-Tax Value	\$97,191	\$127,867	\$158,542	\$176,297	\$219,894	\$250,570	\$281,245
Percentage Change	-57.29%	-33.89%	-10.49%	0.00%	36.31%	59.71%	83.11%

As expected, the dispersion of the more diversified “Y” as compared the “X” scenarios above is smaller. What might be more interesting, and unexpected, is the comparison of the after-tax values of a qualifying disposition of “X” vs. the disqualifying disposition “Y”.

	\$13.56	\$18.64	\$23.72	\$26.00	\$33.88	\$38.96	\$44.04
Qualifying Disposition - X	\$102,000	\$143,253	\$184,506	\$203,000	\$267,012	\$308,264	\$349,517
Disqualifying Disposition - Y	\$97,191	\$127,867	\$158,542	\$176,297	\$219,894	\$250,570	\$281,245
Dollar Difference	\$4,809	\$15,386	\$25,964	\$26,703	\$47,118	\$57,695	\$68,272

You’ll see that the after-tax value of the qualifying disposition of “X” is actually higher than a disqualifying disposition that is reinvested into a more diversified “Y.”

Couple this with the upside potential of the qualifying disposition, and you can argue that that tax buffer offered by a qualifying disposition of incentive stock options might create an opportunity to generate meaningful excess wealth with similar downside risk.

Single Stock Risk/Return May Drive Your Final Value More Than Your Tax Rate

While modeling potential tax implications can be an interesting exercise to value the tax advantage of a qualifying disposition, it goes without saying that you should evaluate your personal financial circumstances prior to implementing any ISO strategy.

While tax modeling may appear attractive on paper, it can quickly be wiped away if you have a single stock that under-performs whatever alternative investment you may choose. Therefore, you need to consider: How much risk are you willing to take? And how much company stock do you want to own?

The generally accepted consensus is that a single stock is more volatile than a basket of stocks. Therefore, it's reasonable to assume that your stock may or may not perform as you hope (or plan for).

The risk that your stock might not perform as you hoped should be addressed in building your financial plan and overall investment strategy. If concentration risk is more than you are comfortable with, or if your concentrated equity position is too high, a disqualifying disposition may be something to consider regardless of the tax outcome.

Other Items That Can Impact the Cash Flow Analysis



The illustration above is one example of what may happen when considering your cash flows for a qualifying and disqualifying disposition. Many other scenarios can impact the analysis.

Some of these include:

The cost of the shares themselves: The higher the cost of exercise, the more money that you will need to buy the shares. This may make a disqualifying disposition more attractive if you are hesitant to absorb negative cash flows required to do an exercise and hold.

A higher cost of exercise may also lead to assuming additional risk of loss. The more money you have in the transaction, the more you can lose if the stock price goes down.

The size of the bargain element: All else being equal, a higher bargain element means paying more in AMT. More AMT means more cash to exercise and hold, leaving less money available for other needs.

A large bargain element may also lead to a greater amount of carryforward AMT credit, and impact how fast you get it back.

The amount of time from your exercise of the ISOs to the final sale: Our example illustrated a scenario in which a qualifying disposition occurs as soon as possible, or one year after exercise. If you extend the holding period, the value of a portfolio that has positive cash flows in early years may be more beneficial if you consider time value of money.

In other words, a dollar today is worth more than a dollar tomorrow. The further you push the sale of the stock into the future, the greater the value of positive cash flow from a disqualifying disposition in year one.

The expected rate of return of your single stock and the alternative investment: The closer the average rate of return and standard deviation of the two investment options, the closer the total values and the greater argument to seek a qualifying disposition.

Additional Planning Ideas for A Qualifying Disposition of Incentive Stock Options

Qualifying dispositions not only have potential tax benefits, but there are also certain planning strategies that may be available to consider with your ISOs once you exercise them.

1 – Exercise Early in the Calendar Year (to Allow for Year End Planning)

A significant AMT bill may have a material impact on whether or not a qualifying disposition is a good or bad idea. The larger the AMT, the greater the negative cash flow required to exercise and hold.

A significant AMT bill may also result in a larger position in one company stock as a percentage of your net worth, as you may need to transfer non-company stock assets into company stock assets. One strategy to manage AMT risk is to exercise early in the calendar year.

Doing so may allow you to sell those same shares early in the following calendar year as a qualifying disposition. Once sold, the proceeds from that transaction may be available to cover the AMT bill itself.

If you wait until after the tax filing deadline to initiate an exercise and hold, you won't be able to sell those shares as a qualifying disposition in time to use the proceeds for payment of tax due.

Exercising early in the calendar year also gives you the opportunity to undo an exercise and hold that is currently subject to AMT. You can intentionally do a disqualifying disposition not subject to AMT.

This may be a good idea if your projected AMT is so large that it exceeds the value of the shares themselves (as it could be if the post exercise value of the stock goes down). To avoid or minimize AMT in this scenario, it may be a good strategy to sell some or all of your previously exercised ISO shares prior to calendar year-end.

The sale will remove the AMT preference item, and you would likely claim the gain as compensation income, subject to ordinary income tax rates. The tax due can be paid with the proceeds of the disqualifying sale itself.

2 – Exercise Up to the AMT Crossover Point (to Reduce a Liquidity Squeeze)

Another way to manage AMT is to exercise and hold just enough shares that your tentative minimum tax equals your regular income tax. If done correctly, you will be able to exercise and hold some of your ISO shares, begin the holding period, and pay no AMT.

This amount of room you have to exercise will be based on your income level and filing status, among other factors. Generally speaking, there is more room in the low- and high-income space, and less room in the middle-income space.

The number of shares that you will be able to exercise will be subject to the spread between the exercise price and the fair market value of the stock and the spread between the tentative minimum tax and the regular tax.

If the larger the spread between the exercise price and fair market value of the stock, the fewer shares you will be able to exercise. The larger the spread between the tentative minimum and regular tax, the greater number of shares you can exercise.

You will want to balance these factors when you implement a strategy.

3 – Exercise When the Spread is Low and/or the Exercise Price is Low (or You are Bullish on the Stock)

It's not uncommon to be excited about the future prospects of your company stock and feel as though the stock price will go up in value. If you find yourself optimistic about your shares and are willing to assume the risk associated with a single stock, you may want to exercise and hold for a qualifying disposition.

By doing so (and assuming you are correct that the stock price goes up), there are two key factors that work in your favor.

First, you likely pay less in AMT than you would have had you wait until the price was higher to exercise. A smaller bargain element, all else being equal, will mean a smaller AMT owed and potentially a greater opportunity to capture long-term capital gains on the stock appreciation.

Second, you begin the holding period necessary to meet the requirements for a qualifying disposition. This ability to sell shares sooner may be particularly relevant if you are looking to combine a qualifying disposition with a life event such a retirement or a target exit price of the stock.

If both the price and the spread are low, it may be time to consider an 83(b) election of your ISOs. This strategy may allow you to exercise unvested ISOs, pay AMT on the bargain element (which may be minimal), and begin the holding period for a qualifying disposition.

This strategy, however, comes with additional risk. Essentially, you must pay for something you may not currently own. If you leave your company or the shares go unvested, you will lose your money in the deal. Talk with an advisor with experience in working with 83(b) elections to help determine if this makes sense for your situation.

What This Means for Financial Planning and Incentive Stock Options

Incentive stock options (ISOs) can be a valuable tool for generating additional wealth. However, to fully take advantage of the potential benefits of an ISO, you'll likely want to consider many, many factors.

These include — but certainly are not limited to — looking at what your tax benefit may be and if that perceived benefit is worth the risk of owning a single stock for a required period of time.

The answer to whether or not you may be comfortable with increasing your concentration risk and holding a single stock to obtain a tax benefit, you might want to take a look at other financial planning questions.

Consider asking yourself:

- ▼ **How close are you to retirement?**
- ▼ **How much of your net worth is allocated to a single stock position?**
- ▼ **What are your short- and long-term employment expectations with the company?**
- ▼ **Are there mandated restrictions on retaining and/or selling your stock?**
- ▼ **What are your expectations of future compensation?**
- ▼ **What's your outlook on the company and its potential?**

As you answer these questions and dig further into tax analyses to determine what outcomes might be best, you may be able to begin developing a financial plan that integrates a strategy for managing your ISOs with an overall plan of action across all areas of your financial life so that everything works in tandem to help you achieve your goals.

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