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Tax Notes

Incentive Stock Option Planning in a Volatile Market

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Taxpayers across many industries receive stock option grants as part of their compensation packages. There are multiple types of stock options, each of which yields unique tax results. The purpose of this article is to focus on Incentive Stock Options (ISOs), particularly in an environment where the value of the shares may have decreased since the date of the option exercise.

ISO Basics

First, some basic rules about how ISOs work. There is no tax impact to the taxpayer when ISOs are granted. Upon exercise, there is no tax impact for *regular* income tax purposes. However, under the Alternative Minimum Tax (AMT) rules, the taxpayer pays tax on the difference between the strike price and the fair market value (FMV) on the date of exercise.

Upon sale, assuming the taxpayer holds the shares for at least 12 months and a day prior to disposition, the taxpayer recognizes a long-term capital gain or loss. For regular tax purposes, the gain or loss is based on the difference between the sale price and the strike price. The gain or loss for AMT purposes is the difference between the sale price and the FMV on the exercise date. The sale of the shares triggers the release of a credit that the taxpayer can use to recover the AMT that the taxpayer paid up front upon exercise.

ISOs in the Current Market

In an economy where stock values are trending higher over time, ISOs allow a taxpayer to exercise when the value is low, and then after holding the shares for more than 12 months, to sell them at gain. By holding the shares long-term, the taxpayer benefits from the lower tax rates on long-term capital gains.

A disqualifying disposition occurs when a taxpayer exercises and sells ISOs within a 12-month period. From a tax perspective, disqualifying dispositions trigger ordinary income and short-term capital gains. In a period of appreciation and growth, typically a taxpayer would not choose to do this, because they would lose the benefit of the lower long-term capital gain rate.

However, in a volatile economy such as what we are currently experiencing, many of our clients are finding that the value of the shares that they received as part of an ISO exercise has declined.

A taxpayer who holds these shares long-term may potentially get “stuck” with large capital carryover losses and credits that can only be recovered gradually if the shares’ value does not return before they are sold. This is because of certain limitations on capital losses that the taxpayer can take each year, generally about $3,000 per year unless there are capital gains available to offset the losses. This is not a great result for the taxpayer, who has actually paid taxes to the IRS in advance based on the higher stock value.

Planning Considerations

We have been helping our clients consider different solutions, so they don’t get stuck paying taxes up front on a value that no longer exists. One idea that may be worth considering in this situation is intentionally selling exercised ISOs in a disqualifying disposition. The short-term sale effectively caps the taxpayer’s income based on the current, lower value. In other words, rather than paying tax based on the value that existed on the date of exercise, the taxpayer will only pay tax based on the value on the date of sale. Although this creates ordinary income both for regular tax purposes and for AMT purposes, the amount of income is lower because of the capped value, and the taxpayer creates liquidity by selling the shares.

A Simple Example

For example, let's say that a taxpayer exercised 10,000 ISOs at $1/share in February 2022 when the value was $10/share. If the taxpayer does nothing else before year end, they will be on the hook for AMT on the built-in value of the shares (10,000 shares x $9/share x 28%, or about $25,000). This prepayment will create a tax credit that is available in future years.

Fast forward to February 2023 when the value is $5/share. If the taxpayer sells the shares after the 12-month holding period, they will receive $50,000 in proceeds.

- For regular tax purposes, despite the decreased value, they'll recognize a long-term capital GAIN of $4/share, or $40,000, because their tax basis is only the $1/share that they originally paid to exercise the options.

- For AMT purposes, they will recognize a long-term capital LOSS of $5/share, or $50,000, because their tax basis under AMT is the $1/share that they paid to exercise the options PLUS the $9/share on which they paid AMT in the previous year. However, because the taxpayer is essentially only allowed to use capital losses to the extent they have capital gains from other sources, this loss may not be fully utilized for several years.

If instead of waiting for the 12-month holding period to be over, the taxpayer decides in December 2022 to sell the shares when the value is $5/share, they will recognize income of only $4/share this year, which will be subject to ordinary tax rates. The tax bill for 2022 would be based on the lower value of the shares since the disposition will occur before the 12-month holding period closes (10,000 shares x $4/share x 37%, or about $15,000). Since the disposition would occur prior to year-end, there would be no lingering tax impact in 2023.

This strategy may not be applicable in all situations, and there are certainly non-tax factors to be considered, as well. There may be black-out periods that the taxpayer needs to work around. The taxpayer may not want to give the appearance of lacking confidence in the company by selling off their shares. The taxpayer may be confident that the future value of the shares will be higher and want to stay invested for the long term.

What to Do Now

This is a complicated area of the tax law, and income tax projections and analysis should be done on a client-specific basis to determine what makes the most sense from a tax perspective in your unique situation.

Contact Us

Please reach out to your PKF O'Connor Davies team to discuss whether the strategy outlined may be beneficial to you or contact:

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