INCENTIVE STOCK OPTIONS

A stock option grants you the right to purchase a certain number of shares of stock at an established price. There are two types of stock options -- incentive stock options and non-qualified stock options -- and they are treated very differently for tax purposes.

Incentive stock options are one of the most popular types of incentives used by companies to attract and keep executives. In most cases, these options provide more favorable tax treatment than ***non-qualified*** stock options, which are generally given to rank-and-file employees.

If you have been granted stock options, make sure you know which type of options you received. If you are not sure, take a look at your option agreement or ask your employer. The type of options should be clearly identified in the agreement.

Why Are Incentive Stock Options More Favorable?

When you exercise incentive stock options, you buy the stock at a pre-established price, which could be well below actual market value. The advantage of an ISO is you do not have to report income when you receive a stock option grant or when you exercise that option. You only need to report the taxable income when you ***sell*** the stock. And, depending on how long you own the stock, that income could be taxed at capital gain rates of 15 percent or less -- a lot lower than your regular income tax rate.

With ISOs, your taxes depend on the dates of the transactions (that is, when you exercise the options to buy the stock and when you sell the stock). The price break between your grant price you pay and the fair market value on the day you exercised the options to buy the stock is known as the ***bargain element***.

There is a catch with incentive stock options, however: you do have to report that bargain element as taxable compensation for Alternative Minimum Tax (AMT) purposes when you exercise the options (unless you sell the stock in the same year).

With non-qualified stock options, you must report the price break as taxable compensation in the year you exercise your options, and it's taxed at your regular income tax rate.

How Transactions Affect Your Taxes

Incentive Stock Option transactions fall into five possible categories, each of which may get taxed a little differently. You can:

1. Exercise your option to purchase the shares and hold them.
2. Exercise your option to purchase the shares, then sell the shares the same day or within the same year.
3. Sell shares less than a year after you purchased them.
4. Sell shares at least one year and a day after you purchased them, but less than two years since your original grant date.
5. Sell shares at least one year and a day after you purchased them, and at least two years since the original grant date.

Each transaction has different tax implications. The first and last are the most favorable; the middle three are the least favorable. The time at which you sell determines how the proceeds are taxed.

If you can wait at least a year and a day after you purchase the stocks, and at least two years after you were granted the option, any profit on the sale -- the difference between the bargain price you paid for the stock and what you sold it for -- is treated as a long term capital gain, so it is taxed at a lower rate than your regular income. This is the most favorable tax treatment, because long term capital gains are taxed at a maximum 15% (or as low as 5% or if you're in the 10% or 15% income tax bracket) compared to ordinary income tax rates which may be as high as 35%. Starting in 2008 and running through 2010, taxpayers in the two lowest income tax brackets will pay no tax on long-term capital gains and qualified dividends.

Sales that meet these one- and two-year time limits are called "qualifying dispositions" because they qualify for favorable tax treatment. No compensation is reported to you on your Form W-2, so you do not have to pay taxes on the transaction as ordinary income at your regular tax rate. Category 5 is also a qualifying disposition.

Unfortunately, if you sell the stocks before they meet the criteria for favorable capital gains treatment, the sales are considered "disqualifying dispositions," and you may end up paying taxes on part of the proceeds of the sale at your ordinary income tax rate, which could be as high as 35%. When you sell the stock two years or less from the offering date, known as the grant date, or one year or less from the exercise date, which is when you purchase the stock, the transaction is a disqualifying disposition. In that case, that compensation should be reported on your Form W-2. The reported amount is the bargain element, which is the difference between what you paid for the stock and its fair market value on the day on the day you bought it. But if your bargain element is more than your actual gain from the sale of the stock, then you report your compensation as the lesser amount of the actual gain. The reported compensation is taxed as ordinary income. (Categories 2, 3, and 4 are disqualifying dispositions).

1. Exercise your option to purchase the shares and hold them.

Grant date	12/31/2006
Exercise date	6/30/2007
Exercise price	$25
Market price on 6/30/2007	$45
Number of shares	100
Bargain element	$2,000

You do not report anything on Schedule D (Capital Gains and Losses) because you have not sold the stock. Your employer will not include any compensation related to your options on your Form W-2, either.

But you will have to make an adjustment for the Alternative Minimum Tax (AMT) that equals the bargain element, which is $2,000 ($45 - $25 = $20; $20 x 100 shares = $2,000). Report this amount on Form 6251, Alternative Minimum Tax, line 13.

2. Exercise your option to purchase the shares, and then sell those shares in the same year.

Grant date	12/31/2006
Exercise date	06/30/2007
Exercise price	$20
Sale date	06/30/2007
Sale price	$45
Number of shares	100
Bargain element	$2,500

The bargain element is the difference between the exercise price and the market price on the day you exercised the options and purchased the stock ($45 - $20 = $25; $25 x 100 shares = $2,500). This amount should already be included in the total wages reported in Box 1 of your Form W-2 because this is a disqualifying sale (meaning you are disqualified from taking it as a capital gain and being taxed at the lower capital gains rate). If this amount is not included in Box 1 of Form W-2, add it to the amount you're reporting on Form 1040, line 7.

Report the sale on Schedule D, Part I as a short-term sale. The sale is short-term because not more than one year passed between the date you acquired the actual stock and the date you sold it. For reporting purposes on Schedule D:

- The date acquired is 6/30/2007
- The date sold is also 6/30/2007
- The cost basis is $4,500.This is the actual price paid per share times the number of shares ($20 x 100 = $2,000), plus any amounts already reported as compensation income on your tax return ($2,500)
- The sale price is $4,500 ($45 times the number of shares, 100). This should match the gross amount shown on your Form 1099-B you receive from your broker after the end of the year.

You end up reporting no gain or loss on the transaction.

Because you exercised the options and sold the stock in the same year, you do not need to make an adjustment for Alternative Minimum Tax purposes.

3. Sell shares less than a year after you purchased them.

Grant date	12/31/2005
Exercise date	12/31/2006
Exercise price	$20
Market price on 12/31/06	$45
Sale date	06/15/2007
Sale price	$30
Number of shares	100
Bargain element	$2,500
Actual gain from sale	$1,000

Unlike the previous example, the compensation is calculated as the lesser of

- The bargain element, that is, the difference between the exercise price and the market price on the day you exercised the options and purchased the stock ($45 - $20 = $25; $25 x 100 shares = $2,500)
- The actual gain on the sale of the stock ($30 - $20 = $10; $10 x 100 shares = $1,000).

In this example, the amount that is considered compensation to you is $1,000, your actual gain, even though your bargain element ($2,500) is higher. This amount may be included in the total wages shown in Box 1 of the Form W-2 from your employer because this is a disqualifying sale, meaning that it does not qualify for treatment as a capital gain (at the lower capital gains rates). If this amount is not included in Box 1 of Form W-2, you must add it to the amount you're reporting on Form 1040, line 21.

In order to be taxed only on the lesser of the two calculations, ($2,500 vs. $1,000 in our example), the sale cannot be any of the following:

1. A wash sale: if you repurchase shares in the same company (such as through an employee stock purchase plan) within 30 days before or after the sale of the shares obtained from the exercise of the option, some or all of the sale will be considered a wash sale. You will not be allowed to report the lesser calculation as income for shares sold in a wash sale. You must report the full $2,500 as income.
2. A sale to a related party: if you sell the shares to a related party (a member of your family, or a partnership or corporation in which you have more than a 50 percent interest), you must report the full $2,500 as income.
3. A gift: if you gave the stock to an individual or a charity, rather than selling the shares, you must report the full $2,500 as income.

Report the sale on Schedule D, Part I, as a short-term sale. It's considered short-term because no more than one year passed between the date you acquired the stock and the date you sold it. For reporting purposes on Schedule D:

- The date acquired is 12/31/2006
- The date sold is 6/15/2007
- The sale price is $3,000. This is the price at the date of sale ($30) times the number of shares sold (100). This amount should be reported as the gross amount on Form 1099-B that you'll receive from the broker that handled the sale.
- The cost basis is $3,000. This is the actual price paid per share times the number of shares ($20 x 100 = $2,000) plus the compensation amount reported on your Form W-2 ($1,000).
- The resulting net gain is zero.

Because this sale did not occur in the same year as the year you exercised the options, you have to make an adjustment for AMT. When you originally purchased the stock, you should have reported an income adjustment for AMT purposes in that year. Find out if this was the case by looking at line 13 of Form 6251 (Alternative Minimum Tax) for the year that you purchased the shares. In our example, the amount that should have been reported in that year was the bargain element ($45 - $20 = $25) times the number of shares (100), which equals $2,500.

So what do you do this year? It's not as simple as reporting the bargain element on Form 6251, line 13, as a ***negative*** amount to reverse the AMT effect you incurred in the year you purchased the stock. We explain what you need to do in our section on Reporting an Incentive Stock Option Adjustment for the Alternative Minimum Tax.

4. Sell shares at least one year and a day after you purchase but less than two years after the grant date

Grant date	08/01/2005
Exercise date	02/01/2006
Grant price	$20
Market price on 02/01/2004	$45
Sale date	06/15/2007
Sale price	$85
Commissions paid at sale	$10
Number of shares	100
Bargain element	$2,500
Net gain	$3,990

The bargain element is calculated as the difference between the exercise price and the market price on the day you exercised the options and purchased the stock ($45 - $20 = $25; $25 x 100 shares = $2,500). This amount should be included in the total wages shown in Box 1 of the Form W-2 from your employer because this is a disqualifying sale (meaning that your gain does not qualify for capital gains treatment for which the rates are lower than for ordinary income). If this amount is not included in Box 1 of Form W-2, you must add it to the amount you're reporting on Form 1040, line 7.

You must report the sale of the stock on Schedule D, Part II as a long-term sale. It is long term because more than one year passed between the date you acquired the stock and the date you sold it. For reporting purposes on Schedule D:

- The date acquired is 02/01/2006
- The date sold is 6/15/2007
- The sales price is $8,490. This is the price at the date of sale ($85) times the number of shares sold (100), or $8,500. We then subtract the commissions paid on the sale (in this example

$10), resulting in $8,490. This amount should be reported as the gross amount on Form 1099-B that you'll receive from the broker that handled the sale.

- The cost basis is $4,500. This is the actual price paid per share times the number of shares ($20 x 100 = $2,000) plus the compensation amount reported on your Form W-2 ($2,500).
- The resulting net gain is $3,990.

Because this sale did not occur in the same year as the year you exercised the options, you have to make an adjustment for AMT. When you originally purchased the stock, you should have reported an income adjustment for AMT purposes in that year. Find out if this was the case by looking at line 13 of Form 6251 (Alternative Minimum Tax) for the year that you purchased the shares. In our example, the amount that should have been reported in that year was the bargain element ($45 - $20 = $25) times the number of shares (100), which equals $2,500. So what do you do this year? You will have to report an adjustment on Form 6251 again, but it may or may not be the reverse of the amount you reported in the year of exercise. We explain how you calculate your AMT adjustment in the section called Reporting an Incentive Stock Option Adjustment for the Alternative Minimum Tax.

5. Sell shares at least one year and a day after you purchase and at least two years after the grant date

Grant date	01/01/2005
Exercise date	02/01/2006
Grant price	$20
Market price on 02/01/2005	$45
Sale date	06/15/2007
Sale price	$85
Commissions paid at sale	$10
Number of shares	100

This sale is a qualifying sale, because more than two years passed between the grant date and the sale date, and more than one year passed between the exercise date and the sale date. Because this is a qualifying sale, the Form W-2 you receive from your employer will not report any compensation amount for this sale.

Report the sale on Schedule D, Part II as a long-term sale. It is long term because more than one year passed between the date you acquired the stock and the date you sold it. For reporting purposes on Schedule D:

- The date acquired is 02/01/2006
- The date sold is 06/15/2007
- The sales price is $8,490. This is the price at the date of sale ($85) times the number of shares sold (100), or $8,500. We then subtract any commissions paid on the sale (in this example $10), resulting in $8,490. This amount should be reported as the gross amount on Form 1099-B that you'll receive from the broker that handled the sale.
- The cost basis is $2,000. This is the actual price paid per share times the number of shares ($20 x 100 = $2,000). Unlike our previous examples, because you didn't report any bargain element as compensation on your Form W-2, you don't have to add any compensation amount to your cost.
- The net long-term gain is the difference of $6,490.

Because this sale and the exercise of the options didn't occur in the same year, you must make an adjustment for AMT. When you originally purchased the stock, you should have reported an income adjustment for AMT purposes in that year. Find out if this was the case by looking at line 13 of Form 6251 (Alternative Minimum Tax) for the year that you purchased the shares. In our example, the amount that should have been reported in that year was the bargain element ($45 - $20 = $25) times the number of shares (100), which equals $2,500. So what do you do this year? We'll explain how you calculate your AMT adjustment in the section called Reporting an Incentive Stock Option Adjustment for the Alternative Minimum Tax.

Caution

Your employer is not required to withhold income or FICA taxes when you exercise an incentive stock option since there is no tax due (under the regular tax system) until you sell the stock. At that point, you might not even still be working for the employer who granted you the option. Although no tax is withheld when you exercise an ISO, you can be sure that tax will be due when you sell the stock, and part of the proceeds of the sale will be treated as ordinary income instead of tax-favored capital gains if you fail to hold the stock long enough to qualify for capital gains treatment. Be sure to plan for that tax bill when you consider the consequences of selling the stock.

We recommend that you refer to your stock option plan document or consult your Human Resources Department for more information about your company's options plan.

Reporting an Incentive Stock Option Adjustment for the Alternative Minimum Tax

If you buy and hold, you will report the bargain element as income for Alternative Minimum Tax (AMT) purposes that equals the bargain element. Report this amount on Form 6251, Alternative Minimum Tax, line 13.

When you sell stock acquired with ISOs, you usually have to report an adjustment for AMT purposes in the year you exercise the options. And when you sell the stock in a later year, you must report an adjustment. But what is the adjustment you should report? It would seem that the adjustment should be the reverse of the adjustment you reported in the year of option exercise, but that's not always the case.

In categories 3, 4 and 5 above, we indicated that an adjustment should be reported on Form 6251 (Alternative Minimum Tax) in the year the options were exercised. That adjustment is actually added to the stock's cost basis for alternative minimum tax purposes (but not for regular tax purposes).

So, in example 5, rather than using a cost basis of $2,000 for AMT, a cost basis of $4,500 ($2,000 plus $2,500 of the AMT adjustment from the year of exercise) should be used. This results in a $3,990 gain for AMT purposes from the sale, which differs from the regular tax gain of $6,490 by exactly $2,500. Is this the adjustment that should be reported on Form 6251 for AMT purposes? Not exactly. It's pretty complicated and is better left to tax preparation software like TurboTax. But if you're really curious how it works, here is what you should do:

1. Get a blank Schedule D (Capital Gains and Losses) form.
2. Fill out this Schedule D, using alternative minimum tax numbers for all of your capital asset transactions instead of regular tax numbers. Many of the numbers you'll use for AMT will be the same as those used for regular tax purposes, but some may be different.
3. Compute the schedule down through line 18.
4. Compare the results from your Schedule D using AMT numbers to those from your ***regular tax*** Schedule D. The difference between the two amounts is the amount that you should report on line 16 of Form 6251.
5. When you compare results on the two Schedule D forms, use this guideline: If Schedule D shows no amount on line 18, use line 17 as the comparing amount (it'll be a positive number). If Schedule D does show an amount on line 18, use that amount (it'll be a negative number).

6. Be careful if one Schedule D shows a positive number and the other Schedule D shows a negative number. The difference between the two will be larger than either number. For example, if your regular tax Schedule D shows a positive $12,000 and your AMT Schedule D shows a negative -$3,000, the difference between the two (and the amount you should report on Form 6251) is actually -$15,000.
7. If the regular tax Schedule D amount is greater than the AMT Schedule D amount, you have a negative adjustment; if the reverse holds true, you have a positive adjustment.

In many cases the amount of the difference will be exactly the same as the negative of the AMT adjustment you reported in the year of exercise. There are situations in which this won't be the case, however. Consider this example:

Assume you exercised options a few years ago and had an incentive stock option adjustment of $40,000. You sell that stock this year at a regular tax gain of $10,000, but because your stock's cost basis for AMT is $40,000 higher than the cost basis for regular tax, you have a net loss for AMT purposes of $30,000 ($10,000 - $40,000). This is fine, except for the fact that deductible net capital losses such as this one are limited to $3,000 ($1,500 if you're married and filing separately from your spouse). This limitation on deductible capital losses applies to computations for both regular tax and the alternative minimum tax. So, while you'll report a $10,000 gain for regular taxes, you'll report only a $3,000 loss for AMT purposes. What do you enter on Form 6251 as an alternative minimum tax adjustment? A negative $13,000 on line 16 (the difference between $10,000 regular tax gain and the -$3,000 AMT loss allowed). That is a far cry from being able to report the entire $30,000 net capital loss for alternative minimum tax purposes. Fortunately you'll be able to carry over the unused portion of the capital loss for AMT purposes of $27,000 (the original $30,000 AMT loss minus the $3,000 used this year).

Beginning in 2007, taxpayers who incurred large AMT tax credit carryforwards due to the exercise of incentive stock options before the tech stock crash in 2000 and 2001 will be able to recover a major portion of their credits over the next six years. This year, they will be able to claim a refundable credit of at least $5,000 or 20% of their long-term unused minimum tax credit, whichever is higher. Any minimum tax credit that is a result of AMT paid in 2003 or earlier is included in the long-term unused tax credit.

To figure the refundable amount of your minimum tax credit, and the AMT refundable credit amount, apply the rules that follow under ***Long-***

term unused minimum tax credit, AMT refundable credit amount, and ***Credit refundable.***

In summary, it is important to take a look at the whole picture of your capital gains and losses for AMT purposes when you sell stock that you purchased via exercising incentive stock options. If the market turns on you after you have exercised your options and the current value of your stock is now less than the purchase price, you could be subject to the alternative minimum tax on the higher purchase price, even if you don't sell the stock. One way around that is to sell the stock in the same year that you bought it, creating a "disqualifying" disposition. That way, you will not be subject to the AMT and you would be subject to regular tax on the difference between your grant price and the actual sales price. For example, assume you exercised options at $3 a share on a day when the stock was selling for $33, and the stock value later dropped to $25. If you sell the stock at $25 before the end of the year, you would be taxed at ordinary income tax rates on $22 per share ($25-$3) and not be subject to the AMT adjustment at all. It may be advisable to consult with a tax professional regarding the tax treatment of your stock prior to a sale, as well as prior to an exercise of options for which a large price break exists.

See IRS Publication 550: Investment Income and Expenses (Including Capital Gains and Losses) and ***Stock Options*** in IRS Publication 525: Taxable and Non-Taxable Income.