StatonWalsh

Financial Clarity Through Transparency

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December 31, 2021

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Incentive Stock Option

An "Incentive Stock Option" (ISO) is an employee benefit through which an employee is granted the right to purchase shares in the employer corporation at a specified price (the "exercise" price), within a fixed period of time. If all statutory requirements are met, and the stock purchased with the ISO is sold at a profit, the gain is taxed at preferential capital-gains rates, rather than at higher, ordinary income tax rates.[1]

ISO plans are often used in larger, publicly held corporations to attract and retain key employees and executives.

Requirement To Qualify For ISO Tax Treatment

Federal income tax law contains a number of requirements that an employer stock-option plan must meet in order for stock acquired via options issued under the plan to receive preferential ISO income tax treatment, including:

- **Written plan:** The ISO must be issued under the terms of a written plan (on paper or in electronic form), approved by the shareholders of the corporation within 12 months of the plan's adoption by the board of directors. The plan must specify the total number of shares that may be issued via ISOs as well identify the employees, or class of employee, the plan is intended to benefit.[2]
- **Time limit on option issuance:** No options may be granted under the plan more than 10 years after the plan is adopted or approved, whichever comes first.
- **Exercise time limit:** An option may not be exercisable for more than 10 years.
- **Exercise price:** Generally, the option's exercise price must not be less than the fair market value of the stock on the date the option is granted.
- **Limited transferability:** The option must not be transferable by the individual to whom it is granted other than by will or the laws of descent and distribution, and it must be exercisable, during the individual's lifetime, only by such individual.

[1] The discussion here concerns federal income tax law. State or local income tax law may differ.

[2] There are no non-discrimination rules; the employer may pick and choose which employees to benefit.

- **Only issued to employees:** The individual receiving the ISO must, at all times, be an employee[1] of the granting corporation for a period extending from the date the option is granted until the day three months before the date of exercise.[2]

- **Required holding period:** Stock acquired under the terms of an ISO must be held for the longer of (1) two years from the date the option was granted, or (2) one year from the date the stock is acquired by the employee.

- **Dollar limitation:** ISO tax treatment is limited to the first $100,000 of aggregate fair market value of stock exercisable for the first time by any individual in any calendar year. Stock acquired via ISOs in excess of $100,000 is generally treated as having been acquired through a "non-statutory" stock option, with different income tax treatment.

- **10% shareholders:** An option is not considered to be an ISO if it is issued to an individual who owns, directly or indirectly, 10% or more of the employing corporation. This restriction does not apply if: (1) the exercise price is at least 110% of the stock's fair market value at the time the option is granted and (2) the option is exercisable for only five years after the grant date.

Federal Income Tax Treatment Of Incentive Stock Options

There is no tax impact at the time an ISO is granted to an employee. Tax issues arise when the option is exercised and when the acquired stock is later disposed of.

- **At time of exercise:** When the employee exercises the option, and purchases the stock, he or she has no income for regular income tax purposes, no employment (FICA or FUTA) taxes are due, and the employer has no business deduction. However, for Alternative Minimum Tax (AMT) purposes, the employee is generally required to recognize the difference between the exercise price and the stock's fair market value as an adjustment in computing AMT. The amount included in income as an AMT adjustment is added to the basis of the stock for computing AMT gain or loss.[3]

[1] Options may not be granted to non-employee directors or independent contractors.

[2] A disabled employee may exercise the option up to 12 months after terminating employment. For a deceased employee, the option may be exercised by the deceased's heirs at any time until the option expires.

[3] No AMT adjustment is required if the option is exercised, and the stock disposed of, in the same calendar year, or if the stock is disposed of in a "disqualifying" transaction.

- **Example 1:** George receives an ISO to purchase 100 shares of his employer's stock at $10 per share. George later exercises the option at a time when the stock is trading at $13 per share. On his income tax return for that year, George must include $300 as an AMT adjustment, the difference between the exercise price and the fair market value on the date he exercised the option. His basis in the stock for regular income tax purposes is $1,000; his basis in the stock for AMT purposes is $1,300.

The tax treatment applicable when stock acquired through an ISO is disposed of depends on whether it is done in a "qualifying" or a "disqualifying" transaction:

- **"Qualifying" disposition:** If a stock option qualifies as an ISO at the time of exercise, and the stock is held by the employee for the required holding period, the gain or loss on the sale of the stock is treated as a capital gain or loss.[1]

  - **Example 2:** Jane is granted an ISO to purchase 100 shares of her employer's stock, at $10 per share. 10 months later, she exercises the option and purchases the stock, paying $1,000 for her 100 shares. Three years after exercising the option, Jane sells the stock for $1,500. For the year of sale, Jane must recognize a long-term capital gain of $500 ($1,500 - $1,000). Her employer is not entitled to any business deduction with regard to the stock acquired through the ISO.

- **"Disqualifying" disposition:** If a stock option qualifies as an ISO at the time of exercise, but the stock is not held by the employee for the required holding period, the difference between the exercise price and the fair market value of the stock at the time of exercise is treated as compensation. Any gain above the fair market value is treated as a capital gain.

  - **Example 3:** Harry is granted an ISO to purchase 100 shares of his employer's stock, at $10 per share. 10 months later, he exercises the option and purchases the stock, paying a total of $1,000 for his 100 shares, at a time when the stock is trading at $12 per share. Six months after exercising the option, Harry sells his 100 shares for $1,500. Because he did not meet the holding period requirements, Harry must, for the year of sale, include $200 in income as compensation, the difference between what he paid for the stock and the fair market value of the shares at the time the

[1] The holding period for capital gain or loss purposes begins on the date the option is exercised.

option was exercised, ($1,200 - $1,000). The remaining $300 ($1,500 - $1,200) is treated as short-term capital gain. If otherwise allowable, Harry's employer is entitled to a business expense deduction for the $200 of compensation. No FICA or FUTA taxes are due and there is no withholding requirement.

Seek Professional Guidance

Incentive stock options represent an opportunity to benefit, on a tax-favored basis, from the long-term growth of a corporate enterprise. Given the complexities of income tax law, and the sometimes volatile nature of securities markets, the guidance of tax and investment professionals is strongly recommended.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

Disclosure Notice

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