Incentive Stock Options and Nonqualified Stock Options

Incentive Stock Options (ISOs)

An ISO is a type of compensation granted to employees where they have an option to buy a certain amount of the company's stock at a specified price beginning on a specified date. The employee receives favorable tax treatment if they exercise their right to buy stock at least one year after being granted the option and wait at least one year to sell the stock from the exercise date. If the latter timeline is not met or the employee exercises more than the maximum allowable ISOs for a given year ($100,000 vested per year), then either all or some of the ISO's revert to non-qualified stock options (NQSOs) with a different tax treatment. ISOs normally must be exercised within 10 years of grant, but this should be verified with the plan administrator. Lastly, ISOs can also trigger alternative minimum tax (AMT) due.

Know the Terminology

Grant Date: When the employee is given the option to purchase employer stock and date of valuation of stock.

Exercise Date: When the employee exercises their right to buy vested employer stock.

Bargain Element: The price difference between the discounted exercise price and current market price of employer stock.

Sale Date: When the employee sells their exercised shares.

Net Unrealized Appreciation (NUA) and ISOs

NUA is the special tax treatment afforded to ISOs. Here is how it works:

- ISO granted 1 Jan 2023; there is no tax consequence on this date. ISOs are granted at the current market price of $30/share.
- ISOs vest for a minimum of 1 year.
- Employee exercises their option to buy stock on 2 Jan 2024 at the grant price of $30/share when the current market price is now $70/share. Bargain element is $40/share. This represents the NUA that will carry forward until stock is sold; no tax is due on this NUA at exercise. Basis is $30/share; used to determine profit after sale.
- Employee holds exercised stock for a minimum of 1 year and 1 day to receive long-term capital gains.
- Employee sells ISOs on 1 March 2025 for $100/share. The profit is $70/share taxed at long-term capital gains rate. Capital gains rate is 0% - 20% depending on AGI tax bracket. Sale date is the only trigger for tax liability; employee will owe taxes on long-term gains on $70/share for the 2025 tax year.

Nonqualified Stock Options (NQSOs)

NQSOs are similar to ISOs in that employees are given an option to buy a certain amount of the company's stock at a specified price at a specified date. NQSOs differ from ISOs in their tax treatment and vesting period. There is no required vesting period between the grant and exercise date. The tax treatment difference occurs at the exercise date; the bargain element is taxed to the employee at ordinary income tax rates. Their basis in this stock is the market price of the stock at the exercise date. At sale date, price difference from basis and sale price is the employee's profit taxed at short-term or long-term capital gains rate depending on how long the stock was held from exercise to sale date.

From the previous example, a similar scenario but with NQSOs:

- NQSO granted 1 Jan 2023; there is no tax consequence on this date. NQSOs are granted at the current market price of $30/share.
- No minimum vesting period; can exercise at any time.
- Employee exercises their option to buy employer stock on 1 Mar 2023. Employee purchases at the grant price of $30/share when the current market price is now $70/share. There is no Bargain element. Employee will pay ordinary income tax for 2023 at $40/share. Basis of stock is now $70/share; taxes are already paid on gain from grant to exercise date.
- Employee holds exercised stock for a minimum of 1 year and 1 day to receive long-term capital gains.
- Employee sells ISOs on 3 March 2024 for $100/share. Employee profit is $30/share taxed at long-term capital gains rate for 2024 tax filing. If the stock was held for less than one year, then the holding period would be considered a short-term capital gain taxed at ordinary income tax rates.

Portability of ISOs and preserving favorable tax treatment

What happens if an employee has exercised their ISOs, but has not sold yet, and they retire or leave their current employer for another job? This is where special care and planning is critical to not lose the NUA tax treatment.

When leaving an employer with exercised ISOs, the employee can transfer those shares to their personal investment or retirement account, for sale at a later date. However, certain transfers can lose the NUA tax treatment and others can preserve it.

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Example A: Transfer ISOs to IRA – Not Favorable

- Employee rolls over lump sum of 100 shares bought when grant price was $30/share, market price at exercise was $70/share, NUA was $40/share.
- While the rollover is a tax-free event, once the shares are co-mingled in the IRA account, they lose their preferred NUA tax treatment.
- When distributions are taken from the IRA, all distributions are taxed at ordinary income rates. Also, the basis is now the original purchase price of $30/share. This will result in a potentially greater increase of stock appreciation for which ordinary tax is due.

Example B: Transfer ISOs to a brokerage account – Favorable

- Must transfer full lump sum of ISOs to brokerage account; any division of ISOs will immediately lose their preferential tax treatment.
- Upon transfer, this is considered a like-kind transfer and ordinary income tax will be due on the portion that represents basis.
- Once the basis is taxed, the remaining value will retain its NUA tax treatment until sale. The holding period clock for long-term capital gains begins once shares are transferred to a brokerage account. If sold at a minimum of 1 year and 1 day from transfer date, then the whole value above basis is taxed at long-term capital gains.

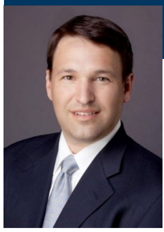
Final Thoughts

While ISOs and NQSOs have various benefits, there are also multiple rules and nuances that can affect your tax liability and methods of transfer once you leave your employer. **At NovaPoint**, our investment, wealth management, and tax experts can help advise you on your employer stock option plans. If you want to explore your employer stock option plans or any other retirement plans, contact us here.

Written by Meghan Hoover, Investment Associate, Financial Planning Team

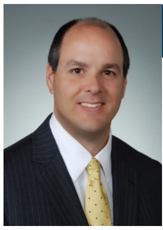
NovaPoint – Financial Planning and Wealth Management

The NovaPoint Team



Joseph Sroka, CFA, CMT / Chief Investment Officer / jsroka@novapointgroup.com

Joe has over 20 years of experience in the investment management industry. Prior to founding NovaPoint, he was a portfolio manager at Spectrum Advisory Services and GMT Capital in Atlanta, and Epoch Investment Partners in New York. He has also worked as an equity research analyst at Merrill Lynch and ABN Amro. Before beginning his investment career, Joe was an Infantry officer in the U.S. Army. Joe holds a BS from the U.S. Military Academy at West Point and an MBA from the University of Chicago. He is both a Chartered Financial Analyst (CFA) and a Chartered Market Technician (CMT).



Alan J. Conner / President and Chief Compliance Officer / aconner@novapointgroup.com

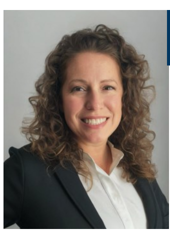
Alan has over 20 years of experience in the investment management industry. Prior to founding NovaPoint, he was a fixed income manager at both Spectrum Advisory Services and a private family office. Alan was also with the Bank Group division of Countrywide Capital Markets where he developed balance sheet strategies for depository institutions. He holds a BS in Banking and an MBA in Finance from Nova Southeastern University. Alan is an endurance athlete and three-time IRONMAN finisher.

Frederick Wright, CFA / Managing Director & Portfolio Manager / fwright@novapointgroup.com

Frederick has over 30 years of experience in the investment management industry. Prior to joining NovaPoint, Frederick was a Partner and Investment Advisor at Brightworth where he advised high net worth investors. Frederick began his investment career in 1991 at Balentine & Co where he rose to Partner. He also co-founded and served as Chief Investment Officer at Wright Investment Management and at Smith & Howard Wealth Management . Prior to beginning his investment career, Frederick served as an Engineer officer in the U.S. Army. He holds a BS from the U.S. Military Academy at West Point and an MBA from Emory University. Frederick is a Chartered Financial Analyst (CFA).

Larry Dixon, EA / Tax Managing Partner / ldixon@novapointgroup.com

Larry leads NovaPoint's accounting, tax and outsourced CFO business. He built his previous company, Atlas Solutions, as a solo entrepreneur before merging into NovaPoint CFO. Larry began his career as a Field Artillery officer in the United States Army. Larry earned his Bachelor of Science degree from the U.S. Military Academy at West Point, where he was a four-year letterman on the football team. Larry is a certified Enrolled Agent, recognized by the U.S. Department of the Treasury to represent taxpayers before the Internal Revenue Service.



Meghan Hoover / Investment Associate / mhoover@novapointgroup.com

Meghan is an Investment Associate focusing on financial planning. Prior to joining NovaPoint, Meghan spent 18 years in government service as an Operations Officer in military intelligence. She holds two Bachelor of Science degrees from the University of Maryland and a Master of Science from the Joint Military Intelligence College. Meghan has additional education specializing in financial planning and is a member of the Financial Planning Association.

Blake McDaniel / Investment Associate / bmcdaniel@novapointgroup.com

Blake is an Investment Associate focusing on financial planning. Prior to joining NovaPoint, Blake served in the United States Army with 7th Special Forces Group, specializing in intelligence. Following his service, he worked as a financial planner in Atlanta. Blake has a Bachelor's degree in business administration and analytics from the American Military University and a Bachelor's degree in finance from Georgia State University.