

The incentive stock option (ISO) gives you the right to buy 1,000 shares of the company's stock at its fair market value (FMV) at the time of the ISO's grant, which is expected to be about \$100 per share, for a five-year period following the grant (it could be a 10-year period if you owned less than 10% of the company's stock).

The grant of the ISO to you won't be taxable. If you later exercise the ISO, you won't be subject to regular income tax as a result of the exercise. For example, if the market value of the stock goes to \$150 per share and you exercise the option and buy the 1,000 shares with a market value of \$150,000 for the \$100,000 option price, you won't owe any regular income tax on your \$50,000 bargain purchase. However, you may be subject to the alternative minimum tax (AMT), as discussed below.

If you sell the stock, say when its value reaches \$200 per share, for \$200,000, then your \$100,000 profit will be taxed in the year of sale. Although the sale is taxable, no income tax will be withheld from your paycheck.

If you want your profit on the sale to be taxed at favorable capital gain rates, you cannot make a disposition of the stock: (1) within two years after the ISO is granted; or (2) within one year after the stock has been transferred to you. A disposition includes a sale, exchange, gift, or similar lifetime transfer.

If you dispose of the stock before both of the required holding periods have expired, then you will have to treat the gain on that premature disposition as ordinary compensation income to the extent of the lesser of: (1) the stock's FMV on the date of exercise minus the option price; or (2) the amount realized on the disposition minus the basis of the stock.

For example, assume again that you buy \$150,000 worth of your company's stock for \$100,000 by exercising the ISO and later sell this stock for \$200,000. The spread between the value on the date of exercise (\$150,000) minus the option price (\$100,000) would be \$50,000. The difference between the amount realized on the disposition of the stock (\$200,000) minus the option price (\$100,000) would be \$100,000. Consequently, your \$100,000 gain on the premature disposition would be ordinary income to the extent of \$50,000—the lesser of \$50,000 or \$100,000.

If you receive less on the premature disposition than the value when you exercised the ISO and the disposition wasn't a sale to a related taxpayer, then the taxable amount is limited to the amount you realized on the sale minus your basis in the ISO stock. For example, if you sold the stock for \$130,000, then you would have \$30,000 of compensation income (\$130,000 amount realized less \$100,000 basis).

By Jan. 31 following the close of the year in which you exercise an ISO, you should receive a statement from your employer that includes such information as the date that the ISO was granted, the date when the stock was transferred to you, the number of shares that were transferred, and the stock's FMV at the time the ISO was exercised. From this information, we will be able to determine how long you need to hold the stock to qualify for long-term capital gain rates or, if you don't hold the stock long enough for this favorable tax treatment, how much additional compensation income will be attributed to you from the ISO exercise.

If you terminate your employment, you must exercise the ISO within three months in order for the favorable tax treatment to apply. There are some exceptions to this requirement if you transfer from one related company to another, such as from a parent to a subsidiary.

For stock acquired under options exercised after Oct. 22, 2004, any remuneration that arises when stock is transferred on the exercise of an ISO or on the disposition of the stock isn't subject to FICA or FUTA taxation. Additionally, any income resulting from a disqualifying disposition of stock acquired under an ISO isn't subject to withholding.

The special tax treatment of ISOs for regular tax purposes—no taxation when the ISO is exercised, deferral of tax until disposition of the stock, and taxation of the entire profit at capital gain rates if the ISO holding periods are met—isn't allowed for AMT purposes. Under the AMT rules, you must include the bargain element, i.e., the difference between the ISO stock's value and the lower price you paid for it, in your AMT income for the year the ISO stock becomes freely transferable or isn't subject to a substantial risk of forfeiture. For most taxpayers, this occurs in the year the ISO is exercised.

This means that even though you aren't taxed for regular tax purposes, you may still have to pay AMT on the bargain element when you exercise the ISO, even though you don't sell the stock, and even if the stock price declines significantly after you exercise the ISO. Under these circumstances, the tax benefits of your ISO will clearly be diminished. However, the potential harshness of this result is ameliorated by the availability of a partial refund for unused AMT credits that are more than four years old.