

Managing Your Employee Stock Options



How concentrated is your portfolio?

Are you over concentrated in your company stock? If your employee stock options represent a large portion of your portfolio, then a risk/return evaluation may suggest developing a more accelerated exercise strategy to give you greater diversification.

Options represent an important growth opportunity when they are held as a part of a well-diversified portfolio. But if one stock makes up a significant portion of your portfolio, this will most likely increase portfolio volatility and risk.

Studies indicate that a good guideline is to keep your largest individual stock holding at no more than 30% of your portfolio. This includes the vested portion of your options as well as company stock in your ESOP, ESPP, 401(k), restricted stock and other company stock you own outright.

If your total exposure to your company stock represents more than 30%, you should consider diversifying.

Is your portfolio at risk?

This worksheet will help you determine if your current level of concentration in your company's stock is exposing you to inordinate risk.

| | You | Example |
|---|----------|---------------------------|
| Company stock owned* | | \$ 300,000 |
| "In the Money" value of vested options | + | + \$ 1,000,000 (A) |
| Total equity in company | = | = \$ 1,300,000 |
| All other investments† | + | + \$325,000 |
| Total investments | = | = \$1,625,000 (B) |
| Concentration | | 80% (A/B) |

In the example shown above, the individual is 80% concentrated in her company stock. If the value of her total company equity drops by 50%, the overall value of her investments will decline to \$975,000—a 40% drop. In a case like this, the investor should consider reducing her position in total company equity to decrease potential risk.

* Include company stock owned in 401(k) accounts and other company-sponsored plans.

† Include value of stocks (other than company stock), bonds, money market funds, mutual funds, etc. held in brokerage accounts, IRAs and retirement accounts..

The difference between NQSOs and ISOs

There are two types of employee stock options: Non-Qualified Stock Options (NQSOs) and Incentive Stock Options (ISOs). The primary difference is in the tax treatment of each type of option. NQSOs are not subject to any special tax considerations. ISOs, on the other hand, are taxed differently and can trigger the Alternative Minimum Tax (AMT) in some circumstances.

Following are examples of how each type of option is treated from a tax perspective when you exercise your options and when you sell them.

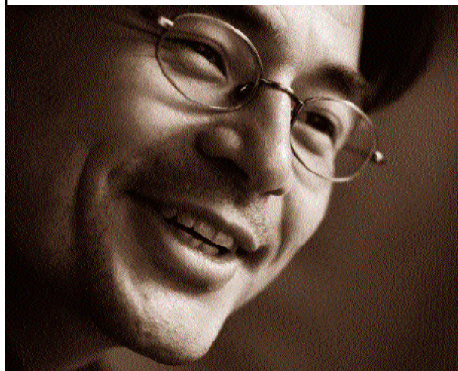
NQSOs and ISOs at a glance

| | Vesting | Exercise | Sale of Stock |
|--------------|--------------|--|--|
| NQSOs | No taxes due | In the money value is taxed as ordinary income | Any gains or losses after exercise treated as capital gains |
| ISOs | No taxes due | No ordinary income tax In the money value is included as Alternative Minimum Taxable (AMT) income | Held one year or less: ordinary income tax Held over one year: long-term capital gains Some AMT paid could be credited against future years' taxes |

NQSOs and Taxes at Exercise: Paul and Ordinary Income Tax

Assumptions:

- Paul exercises 100 vested NQSOs in 2000.
- He has not yet satisfied basic Social Security tax



Here's how Paul would be taxed at exercise:

| | | |
|---|-----------------|-----------------|
| Market price per share on exercise date | \$ 90.00 | |
| Strike price | - 50.00 | |
| Spread per share | \$ 40.00 | |
| Number of options exercised | x 100 | |
| Before-tax Gain | \$ 4,000 | \$ 4,000 |
| Taxes: | | |
| Federal income tax (28%) | \$ 1,120 | |
| State income tax (6%) | 240 | |
| Social Security tax (6.2%) | 248 | |
| Medicare tax (1.45%) | 58 | |
| Total Ordinary Income Taxes | \$ 1,666 | - 1,666 |
| After-tax Gain | | \$ 2,334 |

NQSOs and Taxes Upon Sale: Paul and Capital Gains Tax

Assumptions:

- Paul has exercised 100 NQSOs.
- He holds his shares more than 12 months.
- He has not yet satisfied basic Social Security tax.

Here's how Paul would be taxed upon sale:

| | | |
|---|-----------------|-----------------|
| Sale price per share | \$100.00 | |
| Market price per share on exercise date | \$ 90.00 | |
| Gain per share | \$ 10.00 | |
| Number of shares sold | x 100 | |
| Capital Gain | \$ 1,000 | \$ 1,000 |
| Taxes: | | |
| Federal capital gains tax (20%) | \$ 200 | |
| State capital gains tax (6%) | + 60 | |
| Total Ordinary Income Taxes | \$ 260 | - 260 |
| After-tax gain at sale | \$ 740 | |
| After-tax gain at exercise | + 2,334 | |
| Total After-Tax Gain | | \$ 3,074 |

All investor examples are hypothetical.

How the Alternative Minimum Tax works.

| Year 1—Exercise ISOs | Ordinary Income | Alternative Minimum |
|-------------------------|-----------------|---------------------|
| Salary & Bonus | Included | Included |
| ISO Exercise | Not included | Included |
| Total Income | Smaller | Larger |
| Mortgage & Charity | Deductible | Deductible |
| State & Real Estate Tax | Deductible | Not deductible |
| Total Deductions | Larger | Smaller |
| AMT Exemption | | Deducted |
| Taxable Income | Smaller? | Larger? |
| Rate | Higher | Lower |
| Federal Income Tax | Smaller? | Larger? |

Tips:

- Calculate your tax bill under two different sets of rules.
- AMT includes several forms of income not taxed under the regular rules and excludes certain deductions such as state income and real estate taxes.
- AMT rules often result in a higher taxable income, but tax that income at a lower rate.

Pay the larger number if AMT is larger, generally the difference between the two numbers can be carried forward as a credit against future tax.

Because there are many considerations other than the exercise of your ISOs when you calculate AMT and AMT credit, there is no rule of thumb for estimating its impact. Your tax advisor will need to estimate your tax under both sets of rules, in both years to determine if you will owe AMT or receive a credit.

ISOs and Taxes at Exercise: Michael and the Minimum Tax Credit

Assumptions:

- Michael paid \$12,000 AMT in 1999.
- Because of this payment, he has a \$12,000 minimum tax credit (MTC) available for future years when his AMT liability is less than his regular tax liability.
- His regular 2000 tax liability is \$25,000.
- His tentative 2000 AMT is \$18,000.

Here's how Michael would be taxed at exercise:

| | |
|---|------------------|
| Regular 2000 tax liability | \$ 25,000 |
| Tentative AMT in 2000 | <u>- 18,000</u> |
| Amount of minimum tax credit That can be applied in 2000 | \$ 7,000 |
| Adjusted 2000 Tax Liability | \$ 18,000 |
| Total MTC available starting in 2000 | \$ 12,000 |
| MYC used in 2000 | <u>- 7,000</u> |
| MTC available starting in 2001 | \$ 5,000 |

Michael applies \$7,000 of his available MTC to his regular 2000 tax liability and pays an adjusted income tax bill of \$18,000 in 2000. He still has a \$5,000 MTC to apply to future years.



ISOs and Taxes at Exercise: Katherine and the AMT

Assumptions:

- Katherine's taxable income is \$70,000.
- She does not itemize her deductions, so she takes the standard deduction for a single person of \$4,400.
- She has \$2,800 in personal exemptions.
- Katherine has a \$25,000 spread from exercising ISOs.
- She's single, so her AMT exemption is \$35,750.
- Her regular tax liability is \$14,172.

Here's how Katherine would be taxed at exercise:

| | Qualifying | Disqualifying |
|---------------------------------------|------------------|------------------|
| Regular taxable income | \$70,000 | \$ 70,000 |
| Standard deduction | + 4,400 | 0 |
| Personal exemption | + 2,800 | 0 |
| Spread from ISO exercise | <u>+25,000</u> | <u>+ 25,000</u> |
| Preliminary AMT taxable income | \$102,200 | \$ 95,000 |
| AMT exemption | <u>- 35,750</u> | <u>0</u> |
| Actual AMT taxable income | \$66,450 | |
| AMT tax rate (26%) | x .26 | |
| Tax paid | \$17,277 | 23,651 |
| Regular tax | <u>-14,172</u> | <u>- 14,172</u> |
| AMT | \$ 3,105 | \$ 9,479* |

For a qualifying disposition, Katherine would pay \$14,172 in regular income tax plus \$3,105 in AMT for a total income tax liability of \$17,277. For a disqualifying disposition, Katherine would pay ... need input from client

*Additional tax

ISOs and Taxes Upon Sale: Katherine and Qualifying Disposition

Assumptions:

- Katherine was granted ISOs on 6/1/98 at a strike price of \$5 per share.
- She sells 1000 shares on 6/2/00 after meeting the ISO holding periods.
- Her long-term capital gains tax rate is 20%.

Here's how Katherine would be taxed upon sale:

| | | | |
|----------------------------------|------------------|------------------|------------------|
| Sales price per share | \$ 40 | | |
| Strike price per share | <u>- 5</u> | | |
| Gain per share | \$ 35 | | |
| Number of shares sold | <u>x 1,000</u> | | |
| Before-tax gain | \$ 35,000 | \$ 35,000 | \$ 35,000 |
| Long-term capital gains tax rate | x .20 | | |
| Capital gains tax | \$ 7,000 | <u>-\$ 7,000</u> | |
| After-tax gain | | | \$ 28,000 |

