THE STOCK OPTION TAX DILEMMA FACED BY PRE-IPO COMPANY EMPLOYEES

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When a company goes public or experiences a liquidity event, many employees with unexercised stock options will begin to enthusiastically calculate their windfall. However, their enthusiasm can be quickly dampened once they understand the tax impact. The biggest surprise, if not disappointment, is the amount of taxes they need to pay on their gains when their company goes public or gets acquired. When employees exercise their options after the IPO or as part of the acquisition and sell the stock at the same time, a large chunk of their proceeds goes to pay federal and state taxes. This article explains the tax burden for different types of stock options and explains how exercising your options early can potentially reduce your tax burden now and at the time of a sale.

THE TWO TYPES OF STOCK OPTIONS AND THEIR TAXATION

Companies grant two kinds of stock options: nonqualified stock options (NQSOs), the most common type, and incentive stock options (ISOs). The taxation of your options depends on which type they are.

NQSO Taxation

With NQSOs, you are taxed when you exercise the options and thus acquire the underlying shares of your company's stock. The difference between the fair market value (FMV) of the stock at exercise and your exercise price is called the "spread." For employees, this spread is considered income, and is subject to federal income tax, FICA taxes (Social Security and Medicare), and any state and/or local taxes that also apply. Federal income tax is withheld at a mandatory flat rate of 25% (but 35% for supplemental income over $1 million).

> If your marginal tax rate is higher, you will owe more taxes beyond what your company withholds, paid either through estimated taxes or with your tax return.

In addition, when you sell the shares, any gains above your tax basis (the FMV of the stock at exercise) are taxed at capital gains rates. Shares held more than one year from exercise are taxed at long-term capital gains rates (currently 15%, plus state capital gains rates).

ISO Taxation

Unlike NQSOs, incentive stock options are considered qualified stock options and are subject to potentially more favorable tax treatment. However, ISO taxation is more complex. The tax impact differs from NQSOs in some key ways and depends on when you sell the stock.

For ISOs, there is no tax due at the time of exercise. If you hold the shares long enough before making a qualifying disposition (QD), which is a sale or gift more than one year from exercise and more than two years from grant of ISO shares, all the gain over the exercise price is taxed at favorable long-term capital gains rates.

If the sale of the shares does not meet the QD threshold, it is called a disqualifying disposition (DD). In this scenario, ordinary compensation income and any capital gains or losses can vary according to the relationship between your exercise price, the FMV at exercise, and the sale price. In short, DD situations result in taxable income similar to that of an NQSO. Since many employees in pre-IPO companies do not have the financing available to exercise and hold the ISO stock for a QD, the DD route post-IPO is more common. In addition:

- The spread upon exercise of an ISO may trigger the alternative minimum tax (AMT) if you hold the stock through the calendar year of exercise.
- With ISOs, you have no withholding at all, and do not owe any Social Security or Medicare tax, either at exercise or at later sale.
- Only if you have a DD will income from the ISO exercise appear on your W-2. Any income tax owed from the DD or through triggering the AMT is paid either when your tax return is filed or through estimated tax payments.

NQSO And ISO Taxation: The Basics

TYPE OF GRANT	TAX AT GRANT?	TAX AT VESTING?	TAX AT EXERCISE	TAX AT SALE
NQSOs	No	No	Spread is taxed as compensation	Long-term capital gain if sold more than 12 months after exercise – otherwise taxed as short-term capital gain.
ISOs	No	No	None (Spread is AMT preference)	Long-term capital gain if sold more than 12 months after exercise and 24 months after grant – otherwise taxed as ordinary income and short-term capital gain based on sales price relative to price at exercise.

SHOULD I EXERCISE NOW OR LATER?

So now that we've looked at the differences between NQSOs and ISOs and their respective tax rules, let's consider the question of whether to exercise your stock options now or later. In general, for companies that are experiencing positive growth in share value, the earlier you exercise your options, the better off you will be at the time of exercise. For NQSOs, you will have a lower tax bill at the time of exercise and when you ultimately sell your shares. For ISOs, exercising earlier may reduce the likelihood of having a tax liability at the time of exercise due to triggering the AMT.

For NQSOs, because you must pay ordinary income taxes on the spread between the FMV and the exercise price, the smaller the spread, the less tax you will need to pay upon exercise. In the case of fast-growing companies, this spread will tend to increase over time, so a delay in exercising your options could mean a larger spread and thus a higher tax bill.

For both NQSOs and ISOs, the tax treatment of the gains at the time of sale depends on the holding period of the shares. If you proactively exercise your options before an IPO or liquidity event and hold the shares for more than one year (and in the case of ISOs, more than two years after the option grant), the gains are treated as long-term capital gains rather than ordinary income. Let's look at a couple of examples that illustrate this point.

TAX EXAMPLES

Below are two differing examples in which employees evaluate whether and when to exercise NQSOs in a private company that eventually goes public. To keep the analysis simpler, we focus only on the federal taxes. (These examples are based in part on those provided in the article "Early Exercise Options: Clarifying the Confusion and Risks," by David Cowles, on myStockOptions.com.)

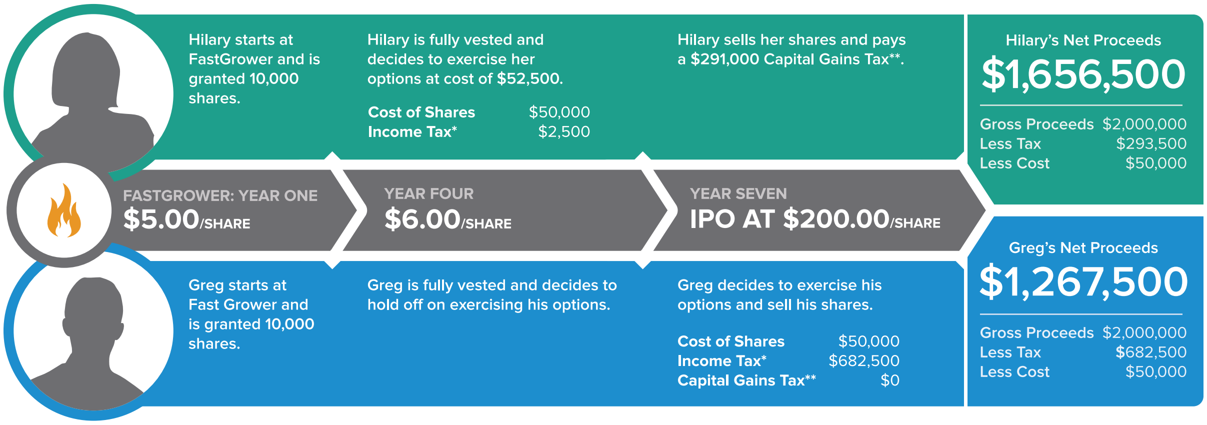
Example 1: Stock Price Soars
Hilary and Greg recently started working for the pre-IPO company FastGrower, Inc. They both are granted nonqualified stock options (NQSOs) to buy 10,000 shares with an exercise price of $5 per share (the current FMV at grant).

The stock price has remained somewhat flat since grant, now valued at $6 per share. When the options are vested after four years, Hilary decides to exercise her options. She writes the company a check for $52,500, which covers the $50,000 cost of the shares ($5 per share times 10,000) and the $2,500 in taxes due (assuming a federal tax rate of 25%, times the $10,000 spread). Greg doesn't have the $50,000 needed to exercise, so he decides to wait until his options vest.

Hilary's timing for exercising when the options vested proves smart. Over the next 24 months, FastGrower comes out with a series of highly successful smartphone apps that support its wildly popular social media website. FastGrower goes public another year later, and its stock price, adjusted for stock splits, eventually soars to $200 per share. Hilary's stock, for which she paid $50,000, is now worth $2,000,000.

Tax Payments Lower
Just over six years after joining the company, with the stock at $200 per share, Hilary decides to sell so she can diversify her investment portfolio. The tax basis in Hilary's stock is $60,000 (the exercise cost plus the income reported to the IRS for it). Hilary's $1,940,000 gain is taxed at the 15% long-term capital gains rate, so she owes $291,000 to the IRS in addition to the taxes paid at exercise ($2,500), for a total of $293,500.

Meanwhile, when the stock price is also $200 Greg exercises his options and immediately sells the shares. After deducting the $50,000 purchase price from the $2,000,000 sale proceeds, Greg has realized a $1,950,000 gain, almost the same as Hilary. But in Greg's case, this entire gain is treated as ordinary income subject to a marginal federal tax rate of up to 35%, or $682,500 (plus additional state and FICA taxes). Hilary's decision to exercise early saved her $389,000 in federal taxes (i.e. the $682,500 Greg paid compared to the $293,500 Hilary paid). Greg's taxes are 133% higher!



*Estimated income tax rate of 45%
**Estimated long-term capital gains tax rate of 20%

Example 2: Waiting To Exercise After Stock Price Appreciation
Let's look at another example using the same assumptions as the previous example: Hilary is granted nonqualified stock options (NQSOs) to buy 10,000 shares with an exercise price of $5 per share (the current FMV at grant).

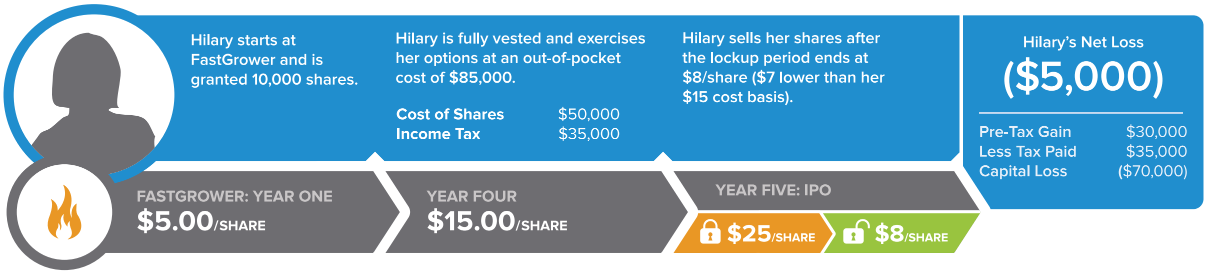
This time, Hilary waits to exercise her options until the stock is at $15 per share. She uses $85,000 in savings to pay for the option exercise, which includes $50,000 for the shares, and $35,000 tax on ordinary income of $100,000 ($10 spread, times 10,000 shares, times 35% federal tax). Her basis in the stock is now $15 per share.

Post-IPO Blues
Within one year after Hilary exercises her options, FastGrower goes public, and the stock price quickly goes to $25 per share. Hilary has a paper gain—so far, so good! However, Hilary soon learns that a large competitor is about to release apps that directly compete with FastGrower's products, which may erode the company's market share.

Unfortunately, since lockup period restrictions still apply, she can't sell the shares to capture the gain. As expected, the release of the competing apps hits the stock price hard. By the time the lockup period ends, the stock is worth only $8 per share. Hilary sells the shares and realizes a pre-tax gain of $30,000 ($8 per share sale price, minus her $5 per share purchase price, times 10,000 shares).

> It can be risky to exercise options in a pre-IPO company if you have to fund the exercise with your own out-of-pocket funds, as the stock price can fall below the FMV price that was used to calculate your taxes.

However, for tax purposes, the sale actually generates a $70,000 capital loss because her tax basis is $15 per share based on the market price when she exercised ($8 minus $15, times 10,000 shares). Recall, though, that she paid $35,000 in ordinary "compensation" income taxes when she exercised (back when the stock was worth $15 per share). Hilary has actually paid more in taxes than her $30,000 pre-tax gain! After deducting the taxes paid, Hilary has an after-tax loss of $5,000. Separately, Hilary may carry forward her $70,000 capital loss to offset capital gains or up to $3,000 per year of ordinary income, but this could take years to use fully.



RISKS IN EXERCISING EARLY

While you reap more after-tax gains by exercising options early in a private company that experiences price appreciation, there are risks if you fund the option exercise with your own personal savings. You need to come up with the funds to exercise, and your cash is then tied up in your company's stock. While secondary markets, such as that available through SharesPost, have developed liquidity solutions for private company stock, many private company shares still have limited liquidity.

You may be holding the shares for an indefinite period until any IPO or acquisition. The shares could also drop in price after exercise or become worthless. While you can take a capital loss on totally worthless stock, this does not result in getting the equivalent of your exercise cost back, and you do not get a deduction for the income previously reported or for the taxes paid.

However, these risks are not insurmountable, particularly if you are able to obtain external financing for the option exercise. Stock option loans can be structured to transfer the investment risk from you to the lender should your company not go public or get acquired, or should the stock after your exercise decline in value or become worthless. These loans, assuming they are properly structured, can help minimize the tax impact of option exercise and transfer the investment risk to a lender.

> It is very important for you to review the loan structure with your own tax advisor to make sure it does not delay the start of the capital gains holding period.

CONCLUSION

There are tax advantages to exercising pre-IPO company options at the earliest opportunity. Your after-tax gains will be larger, assuming substantial stock-price appreciation. However, not every employee has the cash on hand to finance the exercise or the luxury of tying up savings in private company stock. You also face the risk that the shares you acquire could fall in value below the exercise price or become worthless. One solution to both these drawbacks is borrowing to fund the exercise through a loan that you have reviewed with your own tax and legal advisors. For option holders in pre-IPO companies, that is an option worth exploring.

Bruce Brumberg is editor-in-chief and co-founder of www.myStockOptions.com, the premier provider of web-based educational content and tools on stock options, ESPPs, restricted stock/RSUs, performance shares, and SARs. This award-winning online resource center has received a patent and been featured in publications ranging from the San Francisco Chronicle to Money magazine. Human Resource Executive magazine featured myStockOptions.com as one of the 10 Best HR Products.