



ADVANCED PLAN DESIGNS™

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The Economics of ISOs

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Incentive Stock Options (ISOs) are a form of equity compensation that, when administered properly, can be lucrative for those executives receiving them. The following analysis is a breakdown of the requirements and the economic benefits associated with ISOs.

ISO Requirements

Final regulations around (§§1.421-1(j)(2), 1.421-2(f)(2), 1.422-5(f)(2), and 1.424-1(g)(2), offered by the IRS in 26 CFR Parts 1 and 14a (2004), state that an ISO Plan qualifies as such when: "the transfer of stock to an individual pursuant to the exercise of an incentive stock option if:

- 1) no disposition of the share is made within 2 years from the date of grant of the option or within 1 year from the date of transfer of the share, and
- 2) at all times during the period beginning on the date of grant and ending on the day 3 months before the exercise of the option, the individual is an employee of either the corporation granting the option or a parent or subsidiary of such corporation, or a corporation (or a parent or subsidiary of such corporation) issuing or assuming a stock option in a transaction to which section 424(a) applies.

[Further], Section 422(b) provides several requirements that must be met for an option to qualify as an incentive stock option. Section 422(c) provides special rules applicable to incentive stock options, and section 422(d) provides a \$100,000 per year limitation with respect to incentive stock options."

IRS Revenue Bulletin 2004-36 (2004) provides additional guidance on these requirements, including:

- Disqualifying (Qualifying) Dispositions resulting in 83(a) tax treatment
- Sponsor Shareholder Approval of the ISO Plan
- A maximum number of shares must be stated by the ISO Plan
- Option (exercise) price must be equal to or greater than the FMV of the stock at grant
- \$100,000 limitation on aggregate FMV of stock is first considered Statutory, then Non-statutory, where both ISOs and NSOs are available to the participant.



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ISO Economic Benefits

In terms of the income tax treatment of these options, the participant does not incur liability either at the grant or the exercise of such options, provided IRC Section 422 guidelines (above) are met. At exercise, the participant incurs an AMT adjustment; at disposition, capital gain (or loss) income tax treatment is available so long as holding period requirements are met, between exercise and disposition. Finally, no FICA/FUTA tax is incurred by the participant, upon exercise or disposition.

Adding the growth potential of underlying stock to these tax benefits, executives offered an ISO program would be wise to maximize their benefits.

Perhaps the primary downside in an ISO Plan for the participant, is the need for cash to exercise the options. Absent a tandem Cash Bonus plan for the participant, ISOs and their income tax bill (however well managed) can still have a significant “out-of-pocket” cost.

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References

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