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# There's A Time And Place For Nonqualified Options

When it comes to employee stock options, many executives are familiar with incentive stock options (ISOs), also known as qualified stock options. ISOs are often popular with corporate higher-ups because of the preferential tax treatment the options can provide if certain requirements are met. In contrast, nonqualified options (NQOs) largely have managed to fly under the radar. But this other type of employee stock option can offer several advantages .

With either type of option, employees are granted the right to purchase company stock at a fixed price after a specified period of time. The presumed benefit is that the market price of the shares will have risen to a higher value by the time the employee is able to exercise the option. If that's the case, the employee can buy the stock for less than its current market price.

However, there are several key distinctions between the two types of options. With ISOs, the exercise price of the option must equal the stock's fair market value at the time the option is granted. In addition, ISOs are loaded with lots of other restrictions concerning how, when, and to whom the options may be granted. On the plus side, the employee won't realize any taxable income from ISOs until the stock is sold. Even then, if rules for holding periods are met, any gain may qualify as a long-term capital gain and be taxed at a favorable rate.

NQOs operate under a different set of tax rules. Significantly, you must pay tax at ordinary income rates in the year you exercise the option, rather than in the year you sell the stock. As with an ISO, you will recognize tax consequences from any subsequent sale of stock after you exercise the option. However, if your company grants you NQOs, it can claim a deduction for their value in the tax year in which you recognize income from the options. ISOs are not tax deductible.

Let's assume you work for a public company that issues NQOs to executives, but the options themselves aren't traded on any major exchange. When you exercise an option to purchase stock, you owe tax on the discount known as the "compensation element." That's the difference between the exercise price established under the option agreement and the market price of the stock on the day you exercise the option to buy the stock. You can average out the high and low prices of stock trades on that day.

For example, suppose stock in your company is currently trading at $10 a share. Your company grants you an NQO that allows you to exercise 1,000 shares of stock at $12 a share. When the price of your company stock reaches $20 a share, you decide to exercise your option. Thus, your

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## *Wait For November For Clarity On 2013 Tax Policy*

Now that the "payroll tax holiday" has been extended through the rest of 2012, can we expect other significant tax legislation from Congress? Not before the national elections.

Although our nation's lawmakers may still act to keep several other expiring tax provisions, it seems unlikely Republicans and Democrats will reach consensus on the best tax policy for the country before November. Once voters have been heard, Congress will probably get down to business.

Their task is daunting. Several key tax law breaks are scheduled to be scaled back in 2013 if there's no congressional action.

- The two top tax brackets for ordinary income in 2012 are 33% and 35%. Absent new legislation, the two top rates in 2013 will rise to 36% and 39.6%, respectively.
- Currently, the maximum tax rate on long-term capital gains and qualified dividends is 15%. These "Bush tax cuts" are set to expire after 2012 when the capital gains rate will jump to 20% and dividends will be taxed at ordinary income rates.
- For 2012, the maximum estate tax exclusion is $5.12 million, and a surviving spouse may take advantage of any leftover exclusion of the spouse who died. But that "portability" is scheduled to end next year, and the exclusion will revert to $1 million.

We still could see wholesale changes in these tax rules . . . but not until later in the year.

*Robert J. Pyle, CFP, CFA*

# Four Smart Ways To Gift This Year

No one knows for sure what *will* happen to estate and gift tax laws at the end of 2012, but it's crystal clear what *could* occur. Unless Congress acts, the current $5.12-million exemption for estate and gift taxes will drop to $1 million, making it much more expensive to transfer large amounts to your heirs. With that immense change looming, you may want to take action now.

One possibility is to establish an irrevocable trust. You transfer assets to a trust for designated beneficiaries, such as your children, and the high current exemption amount means you're unlikely to face dire estate or gift tax ramifications. But "irrevocable" means just that—you can't get your money back later if you have a squabble with your kids or they make bad lifestyle choices.

Depending on your situation, one of these four alternatives could play a role in your estate plan while helping you take advantage of this year's generous rules.

**1. Self-settled trusts.** Here you essentially give assets away now, using the high current exemption, but you retain the right to get at the money if you need it. Self-settled trusts are available in just a handful of states, but non-residents can transfer assets to a trustee in one of those states. The trustee decides whether an eligible beneficiary can receive a requested distribution, and assets are generally off-limits to your creditors. But the laws in this area are still evolving.

**2. Trust protectors.** You also might establish a trust now but design it to have a third-party protector—such as an experienced relative—who oversees the professional trustee and can remove a beneficiary, veto distributions, amend trust terms, or shift the trust to another state. You also can form committees to make key decisions.

**3. Grantor trusts.** Make sure that any trust you create in 2012 is designated as a grantor trust. As grantor, you'll pay any tax on annual trust income, and those payments won't be treated as gifts now or in future years, when gift tax rules may be more onerous. One sophisticated version is the "intentionally defective irrevocable trust" (IDIT), purposely designed to be treated as a grantor trust while freezing the value of assets for estate tax purposes.

**4. Spousal beneficiaries.** A simpler way to keep access to money while taking advantage of current tax rules is to create a traditional trust and designate your spouse as a "discretionary beneficiary." The trust can be structured to allow occasional distributions to your spouse, who could establish a separate trust for you. But you'll have to do this carefully so the trusts won't be considered reciprocal.

Bear in mind that this is only a brief overview of four gift tax ideas. Obtain more details for your situation. ●

# Stock Option Rules After Job Loss

It may not be the first thing you think about if you're abruptly asked to clean out your desk, but deciding what to do about your stock grants or options could have major financial implications. And the rules are neither simple nor intuitive.

"When someone loses a job, the vesting on outstanding stock options usually stops," says Bruce Brumberg, co-founder of myStockOptions.com, which provides information about stock grants and options. "For options that are already vested, you need to know how long you have to exercise them before they're forfeited."

Rules vary according to the type of stock grant or stock option involved. Some companies make grants of restricted stock or of restricted stock units, or RSUs—similar to restricted stock but with important differences. Other employers provide various kinds of options, with grants sometimes linked to length of employment or to meeting performance goals, that let you buy shares at a specified price, often during a stated time window. Vesting approaches may also vary, with some shares or options vesting gradually and others all at once (known as "cliff" vesting).

In the case of restricted stock and restricted stock units (RSUs), you generally forfeit stock that hasn't vested when you leave the company, while you get to keep shares that have already vested. However, your employment agreement or stock plan may include a provision that protects you if you're terminated after your company is acquired by another firm.

Performance stock or options grants are typically based on whether you achieve goals during a specified period, and if you have to leave before the period ends, you'll lose the shares even if you would have met the objective. If shares or options vest gradually, you'll get to keep only those that have already vested. So, for

# Reap Tax Rewards On Incentive Stock Options

Now that the economy is showing signs of turning around, companies again may be inclined to grant incentive stock options (ISOs) to top-ranking officers and executives. If you're in line for ISOs—or if you received them in the past—you can postpone tax due on any appreciation in your shares' value until you sell the stock. What's more, if you hold the stock long enough, your gain will be taxed at favorable capital gain rates. Still, there are pitfalls to avoid. In particular, you must navigate through a minefield of alternative minimum tax (AMT) rules.

Here's the basic lay of the land: You can benefit from preferential tax treatment on ISOs (sometimes called qualified stock options) if you meet certain requirements. In contrast, nonqualified options (NQOs) are taxable at ordinary income rates as soon as you exercise them. NQOs are simpler, though, and they're generally more favorable to the company, because it can deduct the value of NQOs. That's not the case with ISOs.

To qualify as an ISO, an option's exercise price must equal the stock's fair market value at the time the option is granted. In other words, the company can't provide an immediate discount as it might when issuing a NQO. Other ISO requirements include:

- The option must be granted under a plan specifying the number of shares of stock to be issued and identifying the employees eligible to receive them.
- Shareholders of the employer corporation must approve that plan within 12 months of its adoption.
- The option must be granted within 10 years of the date the plan is adopted or the date of stockholder approval, whichever was earlier.
- The option must be exercisable only within 10 years of the date they are granted.
- If an employee receiving an option owns more than 10% of the voting power of the employer's stock (not counting the stock provided by the option), the option price must equal or exceed 110% of the fair market value of the stock when the option is granted.
- The option cannot be transferable except in the case of the owner's death. Nor can it be exercised by anyone other than the employee during the employee's life.

If you have ISOs meeting these requirements, you don't owe any tax until you sell the stock. Moreover, capital gains will be considered long-term gains if: (1) You sell the stock more than two years after you received the option; and (2) you sell it more than 12 months after you exercised the option. The current maximum tax rate on long-term capital gain is 15%, though that's scheduled to increase to 20% in 2013 barring any year-end legislative action.

To see how this might work, suppose that on January 1, 2010, you were granted an option to buy 100 shares of company stock at $10 a share. You exercised the option on July 1, 2011, when the price was $15 a share. Then you sell the shares on October 1, 2012, at $25 a share. Your taxable gain would be $1,500 (100 shares x the $15 appreciation over the option price). Because you sold the stock more than two years after you received the option and more than one year after you exercised it, the $1,500 gain is considered long term and you owe tax of just $225 (15% of $1,500)—even though you're pocketing $2,500 (100 shares x $25/share). (This illustration is purely hypothetical and not indicative of any stock offering.)

What if you sold the stock at a price lower than the exercise price? You would realize a tax loss on the sale, because your basis is the exercise price. You could use the loss to offset capital gains and up to $3,000 of ordinary income in 2012. However, if the sale price was higher than the exercise price, but lower than the market value on the date you exercised the option, you would still have a taxable gain.

What about the AMT? Exercising an ISO is treated as an adjustment for AMT purposes, and so you may have to pay the AMT in the year you exercise an ISO, though some or all of the AMT liability may be eligible for use as a credit in future years. The stock's basis for AMT purposes is equal to the amount paid plus the amount of the AMT adjustment. That may reduce any taxable gain when the stock is sold.

Of course, AMT liability will be affected by other variables in your personal situation, and any decision to exercise stock options and to sell the shares will be influenced by investment considerations as well as your potential tax liability. This is an extremely complex issue, so be sure to obtain professional assistance before you exercise an ISO. ●

example, if you're granted options to buy 1,000 shares of company stock that have a four-year vesting schedule, with 25% vesting each year, and you're fired after 2½ years, you'll get to exercise the options for 500 shares. With cliff vesting, you'll forfeit the entire grant if you leave before vesting.

If you're forced out, it's crucial to review the rules about grants and options as soon as possible and to exercise options, if that makes financial sense, during a post-termination exercise period that typically lasts 90 days. If you fail to meet the deadline or to adhere to any special terms of a separation agreement, your options will expire.

Finally, if you participated in an employee stock purchase plan, you get to keep shares bought for you while you were employed, but your eligibility to participate ends with your job. The company will have to return any money withheld from your paycheck to purchase shares you didn't receive. ●

# What Are The 401(k) Limits In 2012?

The 401(k) plan continues to be, by far, the most popular company-sponsored retirement plan in the land. And it's no wonder. This unique retirement-saving vehicle offers tax advantages to employees and can also be a valuable tool for employers looking to recruit and retain top talent.

The basic premise is simple: You arrange to have a portion of your pre-tax salary deposited in a separate account. Frequently, an employer will agree to match each dollar that plan participants contribute, up to a specified percentage of compensation. For example, if you earn $100,000 and put $10,000 a year into your 401(k), your company, providing a 3% match, would kick in another $3,000 annually.

There's no current tax on investment earnings within the account, though you also don't get to claim a deduction for losses. Distributions from the account, usually during retirement, are taxed at ordinary income rates. If you change jobs or retire, you normally can choose among keeping the money in your old company's plan, shifting it to a new 401(k), or rolling over some or all of the account to an IRA.

That's the short story. But there are numerous other legal limits and restrictions to contend with. One of the biggest is the annual limit on how much salary you can defer, a number that rises based on an inflation index. Furthermore, the plan must satisfy strict, complex nondiscrimination requirements.

How well do you know the current rules? See how you fare on this brief quiz.

**1) The maximum amount an employed 45-year-old can contribute to a 401(k) in 2012 is:**

a) Zero. c) $21,500.
b) $17,000. d) $22,500.

**2) The maximum amount an employed 55-year-old can contribute to a 401(k) in 2012 is:**

a) Zero. c) $21,500.
b) $17,000. d) $22,500.

**3) The maximum amount a retired 65-year-old can contribute to a 401(k) in 2012 is:**

a) Zero. c) $21,500.
b) $17,000. d) $22,500.

**4) The minimum number of employees required to establish a 401(k) plan is:**

a) 1. c) 25.
b) 10. d) 100.

**5) If you aren't a company's owner, you must begin taking distributions from its 401(k) plan:**

a) At age 59½.
b) At age 70½.
c) When you retire.
d) At age 70½ or your retirement date, whichever comes later.

**6) A rollover from a 401(k) plan to an IRA is subject to a 20% withholding tax unless:**

a) You complete the rollover within 60 days.
b) You arrange a trustee-to-trustee transfer.
c) You retire before the end of the tax year.
d) You are under age 59½.

**7) If you receive a $10,000 "hardship distribution" from a 401(k) in 2012 and you're in the 25% tax bracket, your income tax liability is:**

a) Zero. c) $2,500.
b) $1,000. d) $3,500.

**Answers:** 1-b; 2-d; 3-a; 4-a; 5-d; 6-b; 7-c

## Nonqualified Options

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taxable income in the year of the exercise is $8,000 (market price of $20/share minus exercise price of $12 a share x 1,000 shares).

Suppose you hold the stock for a while and then sell your 1,000 shares at $30 a share. Because your basis is $20 a share (although you paid only $12), you owe tax on a gain of $10,000 ($30/share minus $20/share x 1,000 shares). If you've owned the stock for a year or less, the gain is treated as a short-term gain and is taxed at ordinary income rates. Currently, the top marginal tax rate is 35% (scheduled to increase to 39.6% in 2013). But if you hold the shares for more than one year, the gain will be taxed at long-term capital gain rates. The maximum tax rate is currently 15%, but it's scheduled to jump to 20% in 2013.

To further complicate matters, some high-income people may owe an additional 3.8% Medicare surtax on a portion of their investment income. The extra tax is set to take effect in 2013, barring any action by the government.

Remember that your company must report the compensation element as wages on your Form W-2 in the year you exercise the options. This means the IRS will know all about your good fortune. You'll also be hit with federal payroll taxes on the compensation element.

Finally, be aware that NQOs may offer greater flexibility than ISOs. For instance, you might transfer the options to low-taxed family members, such as your children, before you exercise them. Then your children will be taxed at their low rates on the compensation element. You can't do that with ISOs, which normally can't be transferred. Consult with your financial and tax advisors regarding this idea and other tax planning opportunities. ●

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