Doron F. Eghbali Corporate Law

The discussion in Washington DC and beyond swirls around the ballooning budget deficit and how to fix it. President Obama and top congressional democrats are on record touting tax increases on higher-income taxpayers. As such, this might be the time to rethink some tax strategies.

In fact, many taxpayers seek to put off the tax bill as long as possible. However, this strategy seems to invite higher taxes given the looming passage of health care reform and the accompanying budgetary needs.

Therefore, the following provides a summary of some stock option tax moves:

1. INCENTIVE STOCK OPTIONS

These are deemed to be the best type of stock options because no tax is due when they are granted or exercised i.e. converted into stock.

Incentive stock options are taxed at capital gains rates if:

- The stock is held at least two years from the grant date; and
- The stock is held one year from the exercise.

TAX MOVE FOR INCENTIVE STOCK OPTIONS

So, the best tax move would be to exercise incentive stock options before year-end to be eligible for capital gains rates at the end of 2010.

CAVEAT

But, be careful if you are subject to Alternative Minimum Tax.

2. "NON-QUALIFIED" STOCK OPTIONS

The vast majority of stock options are non-qualified. This means that as opposed to being taxed only upon sale (like incentive stock options), non-qualified stock options are taxed as follows:

- No tax is due until exercise. But, at that point the difference between the amount paid for the stocks and what the stocks' current market value is would be taxed at ordinary income rates and FICA rates.
- After exercise, the stock appreciation would be taxed at capital gains rates, if the non-qualified stocks are held from the date of exercise for more than one year. But, upon sale there are no more FICA tax levies.

TAX MOVES FOR NON-QUALIFIED STOCKS

The problem is if you have to exercise, you have to come up with money to pay ordinary income taxes on any gains. There are two ways:

- To exercise and sell at once. Then, you do not have the stocks, but you have money in hand to pay for any gains at ordinary income rates.
- To exercise and sell enough shares to cover the costs of keeping others.

3. RESTRICTED STOCKS

These are stocks that are tied to performance or length of tenure. Because these stocks have restrictions, no tax is due until the restrictions disappear. At that point, the stock's entire value is subject to ordinary income tax rates and FICA taxes.

TAX MOVES FOR RESTRICTED STOCKS

- There is a way to pay at current tax rates. You can make what is called an "83(b) election". You would have to pay income and FICA taxes by making an election within 30 days of the grant. The appreciation will be taxed at capital gains rates. But, if an employee forfeits the stocks, the taxes are not recoverable.

CAVEAT: WASH-SALE RULE

If you want to take losses by selling your stocks before the end of the year, you must be mindful of wash-sale rule.

The rule prohibits taking losses while buying the same stock 30 days before or after the sale.

The grant of options, restricted options or option exercise are all considered buying stocks. So, keep taking your stock losses and option transactions far apart.

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