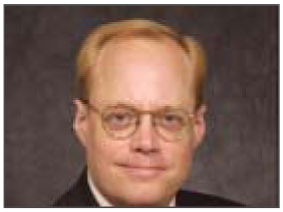

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Got Stock Options? Watch Out

(Image credit: Getty Images via @daylife)

There are two types: incentive stock options (ISOs) and non-qualified options (NSOs). Some employees receive both. Your plan or option grant should specify.

ISOs are taxed most favorably. There's no tax on grant and no "regular" tax on exercise. You pay tax when you sell your shares, hopefully as long-term capital gain. Although the usual long-term holding period is one year, to get capital gain for ISO shares you must:

- Hold the shares for more than a year after you exercise; and
- Sell the shares at least two years after your ISOs were granted.

This two-year rule catches many by surprise. Worse still, while exercising ISOs triggers no ***regular*** tax, it triggers ***alternative minimum tax*** (AMT). You don't generate cash when you exercise ISOs so you have to pay your AMT with other funds.

Non-Qualified Options. NSOs are taxed less favorably but at least there's no AMT trap. As with ISOs, there is no tax when the option is granted. But when you ***exercise*** you owe ordinary income tax (and, if you are an employee, payroll taxes) on the difference between your price and the market value.

Restrictions. If you receive stock or other property from your employer with conditions attached (say you must stay for two years to get it or keep it), special restricted property rules apply. Section 83 of the tax code combined with stock option rules can create confusion.

Say your employer promises that if you remain with the company for 36 months, you will get $50,000 worth of shares. You don't have to "pay" for the stock, but it is given to you in connection with performing services. There's no tax until you receive the stock. At that time you have $50,000 of wages (or more or less, depending on how those shares have done in the meantime.)

This "wait and see" approach doesn't work with restrictions that never expire. With "non-lapse" restrictions, the IRS values the property taking the restrictions into account. Nevertheless, you can include the value of the property in your income earlier (in effect disregarding the restrictions) by making an 83(b) election. See [Top Tax Tips From Zuckerberg's Facebook Bonanza.] Electing to include it in income ***early*** sounds odd, but the goal is to include it in income at a low value, locking in capital gain treatment for future appreciation.

The restricted property and stock options rules are tougher to apply in combination. You may be awarded stock options (ISOs or NSOs) that are restricted—your right to them "vests" over time if you stay with the company. The IRS generally waits to see what happens.

Thus, if your options don't vest for two years, there's no tax until then. At that point, you pay tax under the ISO or NSO rules. It is even possible to make 83(b) elections for compensatory stock options.

Get Some Help. These tax rules are complicated and you may have a mix of ISOs, NSOs, restricted stock and more. It usually pays to get professional help.

For more, see:

Ten Tax Tips For Stock Options

Grab Your Fistful Of Zuckerberg's IPO Dollars

IRS Stock Option Reports Are Due Jan. 31

Why Americans Want A Buffett Tax

Sell Then Rescind? IRS Respects Some Do-Overs

Only The Little Kardashians Pay Taxes

Want A Piece Of Nasdaq's $40M Facebook Settlement?

Facebook IPO Lawsuits: Will IRS Share?

Grab Your Fistful Of Zuckerberg's IPO Dollars

A Jeremy Lin Tax? Yup, and Better Than Buffett's

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