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Tax-Savings Opportunity for NQSO Holders

Presented by FourFront Advisors

If you're lucky enough to hold nonqualified stock options (NQSOs), you may be wondering what they're worth right now. Perhaps you've been fortunate enough to see your company's share price increase since you received your NQSOs, but you've been waiting to exercise your options. Now, given the recent market downturn and volatility, you may feel as though you missed your chance to lock in maximum profits. That's not necessarily true. But, true or not, the current market environment could present a different kind of opportunity when you exercise your NQSOs.

Many investment experts expect to see the markets make a rapid rebound later in 2020, although a recovery is not guaranteed. Assuming the markets do bounce back, say you have already exercised your options at a low valuation and held onto your shares. If your company share price rebounds, you could realize a tax savings when you sell your shares. If you wait to exercise your NQSOs till after the recovery, however, you might owe more in taxes. Let's take a closer look.

An Attractive Benefit

As the holder of an NQSO, you have the right, or "option," to purchase shares in your company at a preset price. You can exercise your option to buy a specific number of shares at the set price during a specified period of time. Typically, a time-based vesting schedule is used, meaning that you must be employed by the company for a certain period before you're free to exercise your options. Vesting can also be tied to individual or company performance. NQSOs usually expire 10 years after the date they were granted, which creates a limited window of time for exercising them. Refer to your stock plan and grant agreement for the specific terms of your NQSOs.

NQSOs are referred to as "unqualified" because they do not qualify for special favorable tax treatment under the U.S. Internal Revenue Code. (A 401(k) is an example of a "qualified" plan that does have tax advantages.) An NQSO is considered "in the money" when the exercise price is lower than the market price of the stock. The difference between the exercise price and the market price is commonly referred to as the "spread." At the time you exercise your option to buy stock shares, the spread is subject to ordinary income tax and social security and Medicare taxes.

A Strategic Opportunity

Depending on your company's share price, you may be able to exercise NQSOs that are in the money, even if their price is significantly lower than at a previous point in time. If you do

exercise your NQSOs and acquire stock while the share price is low, you'll realize less ordinary income on the spread. That means you would owe less taxes on the spread. Subsequently, if you hold the stock for at least one year, any additional appreciation would be taxed at long-term capital gains rates when you sell your shares.

Depending on your tax rate, exercising NQSOs now and holding the stock for one year could result in significant tax savings over simply exercising your shares once the stock price rebounds. (That's assuming that the stock price does rebound.) Long-term capital gains are taxed at either 0 percent, 15 percent, or 20 percent, depending on your taxable income. Ordinary income rates climb as high as 37 percent for the highest earners. Here's an example of how this strategy could play out.

Tax-saving scenario. You have NQSOs granting you the right to buy ABC stock at $10 per share. ABC was recently trading as high as $20 per share, but its price has dropped to $15 per share. You decide to exercise your options now, while the price is down 25 percent from recent highs. You purchase 10,000 shares of ABC stock at $10 per share (your exercise price). This transaction results in $50,000 of ordinary income ($5 spread x 10,000 shares = $50,000).

As for taxes, assume that this $50,000 gain brings your taxable income to $400,000 and you're married and filing jointly. Your effective tax rate would be approximately 21 percent, so you would owe $10,500 ($50,000 x 0.21 = $10,500) in ordinary income taxes at the time of exercising your NQSOs.

One year or more later, assume that ABC stock is trading at $20 per share. You could sell the stock and recognize only $5 per share in long-term capital gains ($20 sale price – $15 cost basis = $5 long-term capital gains). Based on your income level, this gain would be taxed at a rate of 15 percent, creating $7,500 in tax liability. This amount brings your total tax bill on the exercise of the options and subsequent sale of the stock to $18,000.

If, however, you wait to exercise your options until the stock price rebounds to $20, the spread on each share would be $10 ($20 market price – $10 exercise price = $10 spread). You would recognize an additional $100,000 in ordinary income, which would bring your total taxable income to $450,000. At an effective tax rate (assuming the $450,000 in taxable income) of approximately 22 percent, you would owe a total of $22,000 in income taxes on the spread you recognized upon exercise ($100,000 x 0.22 = $22,000).

The result? By waiting for the stock price to rebound before exercising your NQSOs, you would owe $4,000 (or 22.2 percent) more in taxes.

Some Critical Considerations
Please keep these three considerations in mind regarding this strategy:

1) You must buy and hold the stock. It's important to remember that the strategy described above works only if the stock options are bought and held for at least one year. In order to receive the lower long-term capital gains tax treatment, you must own the stock for one year or more. If you sell before meeting the holding period for long-term capital gains, any additional

appreciation would be considered a short-term capital gain. Therefore, it would be taxed at ordinary income tax rates.

2) You must cover the exercise price with cash. This strategy requires you to come up with the cash to cover the exercise price of your NQSOs. There are ways to exercise options that don't need a cash outlay, but they don't allow you to hold the stock and benefit from future appreciation. For these reasons, this strategy does require a certain level of liquidity. Furthermore, in order to realize the tax savings described, you would not be able to sell the stock for at least one year.

3) You should consider your taxable income. In the scenario above, the couple had taxable income of $400,000. If your taxable income level is below this amount, you would see less of a tax savings. That's because your effective tax rate would be closer to the long-term capital gains rate of 15 percent. On the flip side, if you're a higher earner, the tax savings may be more significant, as your effective tax rate may be much higher than the 20 percent capital gains rate. It's important to consult with your tax professional to understand what your effective tax rate is, and at what rate your capital gains would be treated.

To sum up, while no one likes to see a stock option plan lose value, this downturn could present a valuable opportunity for tax planning, tax management, and, eventually, tax savings.

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