

Be Tax-Smart with NQDC and Stock Options

Executives are often rewarded for their business acumen with nonqualified deferred compensation (NQDC) and stock options. To keep taxes to a minimum, it's important to be just as smart when it comes to tax planning for these complicated forms of compensation. This means both understanding the unique rules that apply to each compensation type and taking steps to use them to your advantage.

NQDC plans

These plans pay executives in the future for services currently performed. They differ from qualified plans, such as 401(k)s, in several ways. For example, NQDC plans can favor highly compensated employees, but any NQDC plan funding isn't protected from an employer's creditors.

One important NQDC tax issue is that employment taxes are generally due once services have been performed and there's no longer a substantial risk of forfeiture — even though compensation may not be paid or recognized for income tax purposes until much later. So, your employer may withhold your portion of the employment taxes from your salary or ask you to write a check for the liability. Or your employer may pay your portion, in which case you'll have additional taxable income.

Keep in mind that the rules for NQDC plans are tighter than they once were, and the penalties for noncompliance can be severe: You could be taxed on plan benefits at the time of vesting, and a 20% penalty and potential interest charges also could apply. So check with your employer to make sure it's addressing any compliance issues.

Incentive stock options

Incentive stock options (ISOs) receive tax-favored treatment but must comply with many rules. ISOs allow you to buy company stock in the future (but before a set expiration date) at a fixed price

equal to or greater than the stock's fair market value (FMV) at the date of the grant. Therefore, ISOs don't provide a benefit until the stock appreciates in value. If it does, you can buy shares at a price below what they're then trading for, as long as you've satisfied the applicable ISO holding periods. Here are the key tax consequences:

- You owe no tax when the ISOs are granted.
- You owe no regular income tax when you exercise the ISOs.
- If you sell the stock after holding the shares at least one year from the date of exercise and two years from the date the ISOs were granted, you pay tax on the sale at your long-term capital gains rate.
- If you sell the stock before long-term capital gains treatment applies, a "disqualifying disposition" occurs and any gain is taxed as compensation at ordinary-income rates.

AMT ALERT!

In the year of exercise, a tax preference item is created on the difference between the stock's FMV and the exercise price (the "bargain element") that can trigger the AMT (Alternative Minimum Tax).

If you've received ISOs, plan carefully when to exercise them and whether to immediately sell shares received from an exercise or to hold them. Waiting until just before the expiration date to exercise ISOs (when the stock value may be the highest, assuming the stock is appreciating) and holding on to the stock long enough to garner long-term capital gains treatment often is beneficial. There are several situations in which acting earlier can be advantageous:

- Exercise early to start your holding period so you can sell and receive long-term capital gains treatment sooner.
- Exercise when the bargain element is small or when the market price is close to bottoming out to reduce or eliminate AMT liability.
- Exercise annually so you can buy only the number of shares that will achieve a breakeven point between the AMT and regular tax and thereby incur no additional tax.
- Sell in a disqualifying disposition and pay the higher ordinary-income rate to avoid the AMT on potentially disappearing appreciation.

On the negative side, exercising early accelerates the need for funds to buy the stock, exposes you to a loss if the shares' value drops below your exercise cost, and may create a tax cost if the preference item from the exercise generates an AMT liability

Nonqualified stock options

The tax treatment of nonqualified stock options (NQSOs) is different from that of ISOs: NQSOs create compensation income (taxed at ordinary-income rates) on the bargain element when exercised (regardless of whether the stock is held or sold immediately), but they don't create an AMT preference item.

You may need to make estimated tax payments or increase withholding to fully cover the tax on the exercise. Also consider state tax estimated payments.



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