

### #39: Timing the NQSO Exercise Decision

Non-qualified stock options (NQSOs) are any options granted to an employee for services rendered that don't qualify as incentive stock options (ISOs). The tax consequences of NQSO are as follows:

- Grant—No tax consequences unless option has ascertainable value (rarely the case)
- Exercise—ordinary income equal to FMV minus exercise price (spread)
- Sale of underlying stock—capital gain equal to sale price minus exercise price

**Example 1.** T receives an NQSO with a strike price of \$100 on January 2, 2022. Assume that T's combined state and local ordinary income tax rate is 40% and T's combined state and local long-term capital gains rate is 20%. T exercises the option on January 2, 2024. The FMV of the stock on this date is \$120. T recognizes \$20 of ordinary income as of the date of exercise. There are no further tax consequences until the underlying stock is sold. T sells the stock on January 2, 2026 when the FMV of the stock has increased to \$200. At this time, T recognizes capital gain equal to the difference between the amount of the sale proceeds (\$200) and his basis in the stock (\$120), or \$80. Thus, T has \$20 of ordinary income and \$80 of capital gain. The total tax payable is \$24  $[(.4 \times \$20) + (.2 \times \$80)]$ .

On the surface, it might appear that the earlier the taxpayer can exercise the options the better the economic result will be. The longer the taxpayer waits to exercise, the more capital gain is converted to ordinary income.

**Example 2.** Assume the same facts as in Example 1 except that T waits until the end of the option term to exercise and sells the stock received on the same day. T now has \$100 of ordinary income ( $\$200 - \$100$ ) and no capital gain, making the total tax payable \$40 instead of \$24.

#### Advantage of Late Exercise

It turns out, however, that notwithstanding the unfavorable tax consequences, taxpayers are generally better off waiting as long as possible to exercise their NQSOs. The economic benefit of an NQSO is that its owner gets the benefit of any increase in value of the underlying stock without paying anything to get it. In effect, the owner gets a double return on her money—the growth on the stock underlying the option plus whatever return the money saved by not paying the exercised price earned during the period between the early exercise date and the later exercise date. The longer the owner has the use of this “side fund” to invest, the better. This benefit will generally outweigh the unfavorable income tax consequences of late exercise. By contrast, if the owner exercises early he gets only the growth on the underlying stock. The double return benefit of late exercise will generally outweigh its unfavorable income tax consequences.

**Example 3.** Assume the following facts.

- T is granted an NQSO
- Strike price = \$100
- Present FMV of underlying stock = \$100

- NQSO expires in seven years
- T has one option + \$92.94 in a side fund
- The stock price will increase at 10% per year
- The value of the side fund will increase at 8% per year
- T's ordinary income rate = 40%
- T's capital gain rate = 20%

#### Scenario 1—*Exercise in Two Years*

- FMV of stock after 2 years = \$121
- Tax payable on exercise = \$8.40 (.4 x \$21)
- Value of side fund after 2 years = \$108.40
- T uses full \$108.40 from side fund to pay tax on exercise
- Remaining value in side fund = \$0
- Value of stock at end of 7-year option term = \$194.87
- T sells stock for \$194.87
- Tax on gain = \$194.87 - \$121.00 = \$73.87
- All gain is long-term capital gain
- Tax payable = \$14.77 (.2 x \$73.87)
- T ends up with \$180.10 from stock (\$194.87 - \$14.77)
- Side fund is gone
- Total to T after tax = \$180.10

#### Scenario 2—*Exercise at End of Term*

- Side fund grows to \$159.28 after 7 years
- T exercises option
- This reduces side fund by \$100
- \$59.28 left in side fund
- FMV of stock at end of term = \$194.87
- Ordinary income on exercise = \$94.87
- Tax on exercise = \$37.95 (.4 x \$94.87)
- Leaves \$21.33 in side fund (\$59.28 - \$37.95)
- T sells stock for \$194.87
- No capital gain on sale (T's basis = \$194.87)
- Total to T after tax = \$216.20 (\$194.87 + \$21.33)
- This is \$36.10 more than in Scenario 1 (\$216.10 - \$180.10)

#### *Explaining the Results*

- Growth in side fund from year 2 to year 7 = \$50.88 (\$159.28 - \$108.40)
- This is a benefit for Scenario 2
- Tax payable in Scenario 2 = \$37.95 OI
- Tax payable in Scenario 1 = \$23.17 (\$8.40 OI + \$14.77 CG)
- Extra tax paid in Scenario 2 = \$14.78 (\$37.95 - \$23.17)

- Net benefit in Scenario 2 = \$36.10 (\$50.88 - \$14.78)

### Non-Tax Considerations

The foregoing analysis focused on the tax aspects of the NQSO exercise timing decision, but there are also important non-tax considerations. Most of these factors favor early exercise. First, option holders don't receive dividends on the underlying stock until the options are exercised. This factor could make an important difference if dividends are expected to be substantial. Second, the taxpayer might not consider the underlying stock a good investment. If so, it might be better to exercise the NQSOs early, sell the stock and make more favorable investments. Third, the taxpayer might have a concentrated position in the employer stock. Assuming that the company doesn't discourage early exercise, it might be best to exercise early, sell the stock and diversify the portfolio. Fourth, the taxpayer might need the money and can't afford to wait for it. Finally, early exercise might become more favorable if tax rates are expected to increase substantially in the future. Taxpayers may also wish to spread out exercise to avoid bunching income in one tax year and pushing themselves into higher tax brackets.

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