

Year-End Tax & Planning Issues For Employees



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Tax and financial-planning topics for participants: year-end 2011

1. Income shifting: tax increase in ordinary income and capital gains rates, along with Medicare, in 2013
2. Social Security tax in 2011 and 2012
3. Netting of income, including tax-loss harvesting and myths with company stock sales and underwater stock options
4. Wash sale rule for selling stock at loss
5. ISOs exercise/hold earlier in year, stock dropped



Tax and securities laws important to review for year-end 2011

6. Dates for exercise and vesting at very end of year
7. ESPP sales when stock price has been volatile
8. Gifts of company stock
9. Refundable AMT credit
10. Executive/high net worth topics: hedging; 409A elections; Rule 10b5-1 plans

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Articles

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▶ **Ten Ideas For Year-End Tax Planning With Stock**
The myStockOptions.com Editorial Team & Contributors
UPDATED FOR 2011! Consider year-end or year-beginning tax planning for your stock options and company stock. While investment objectives, not tax consequences, generally drive your decisions, here are 10 ideas to review to prevent paying more taxes than necessary.

▶ **Year-End Strategies For Restricted Stock: Ideas To Consider** [_mso+](#)

Bruce Brumberg

As part of your year-end and year-beginning tax planning, don't forget to review your holdings in restricted stock, performance shares, and other company stock you may own. This article presents strategies that many experts suggest.

▶ **Year-End Strategies For Employee Stock Purchase Plans: Ideas To Consider** [_mso+](#)

Matt Simon

When you think about year-end financial and tax planning, don't forget to review shares acquired through an employee stock purchase plan. This article outlines issues and strategies to contemplate.

▶ **Stockbrokers' Secrets (Part 3): Year-End Planning For NQSOs, Restricted Stock, And RSUs** [_mso+](#)

W.E.B. Bantling and Michael Beriss

UPDATED FOR 2011! The time for tax planning is *before* the year ends; tax season is too late. Learn about several year-end ideas that apply to nonqualified stock options (NQSOs) and restricted stock/RSUs. Meanwhile, look ahead at the likelihood of tax rate changes under President Obama.

▶ **Stockbrokers' Secrets (Part 7): Year-End Planning For ISOs** [_mso+](#)

W.E.B. Bantling and Michael Beriss

UPDATED FOR 2011! Learn about year-end planning specifically for incentive stock

Engaging, informative articles and FAQs on these topics. In a special section and on home page.



Increase in ordinary income and capital gains tax rates

- Income shifting at **year-end, traditional strategy**: spread out NQSO exercise over year-end and year-beginning if exercising all now would push individual into higher tax bracket.
- With **restricted stock/RSUs**, tax at vesting (unless 83(b) or deferral available), so **cannot control when taxed**. Thus income shifting around restricted stock.
- Given the current political stalemate in Congress and the presidential election ahead in 2012, it is unlikely that tax rates will change in 2012. This should simplify your financial planning at the end of 2011.
- Tax rates may go up after 2012, when current rates expire. Only shares purchased or vested in 2011 have guarantee of 15% capital gains rate.
- Unless you were already definitely intending to sell company stock soon, many experts say that concerns about future tax increases should not be the only reason for actions now.



Medicare tax increase

- In 2013, the Medicare tax rate will rise to 2.35% (from 1.45%) for individuals with annual incomes over \$200,000 and couples with incomes over \$250,000.
- In addition, starting in 2013 a new 3.8% Medicare tax will apply to investment income, such as dividends and stock sale gains, for people in the top tax brackets.
- If you have incentive stock options, you may want to consider an exercise and hold in 2011 for the ISOs you planned to exercise in 2012. This would help you avoid the new Medicare tax if you intend to sell the ISO shares for favorable tax treatment after holding them for one year.



2. Social Security

- Social Security wage-base maximum: \$106,800 for 2011 (Medicare uncapped). Increase in 2011 to \$110,100.
- We assume rate will stay at 4.2% in 2012 (normally 6.2%). Maximum \$4,485.60 (savings of \$2,136) in 2011. Maximum \$4624.20 in 2012 (normally \$6,826.20, saving \$2,202).
- If income at year-end already exceeds the Social Security wage base for the year, by exercising nonqualified stock options (NQSOs) or stock appreciation rights (SARs) in December **you can avoid the Social Security tax** (1.45% Medicare tax is uncapped).
- If you wait until January, your wage base for the year starts at \$0, and Social Security tax will again apply on option exercise spread or vesting value of restricted stock up to the new maximum for the year.
- **If not over the maximum, no need to accelerate NQSO exercises into 2011, assuming 2% cut extended to 2012.**



3. Netting of capital gain/loss

- Capital gains and losses net each other out on Schedule D. Matching losses with gains is called “tax-loss harvesting.” **Year-end strategy of great focus. Now reaping what harvested.**
- Up to \$3,000 (joint filers) in losses can be netted against ordinary income, with remainder carrying forward. Perhaps amount will go up with tax law changes/reform in the future?

Example:

- Sold stock last year at a short-term capital loss of \$9,000.
- This year, sold company shares for short-term capital gain of \$5,000.
- Two transactions net each other out on IRS Schedule D, leaving \$4,000 of unused losses (assuming no other sales or loss carry-forwards).
- \$3,000 is used to offset ordinary income on your 2011 tax return and \$1,000 is carried forward.



Two myths about netting of income with stock options, restricted stock, and ESPPs

- When stock is sold immediately upon option exercise, restricted stock vesting, or ESPP purchase, ordinary income is generated, not capital gain income. **Capital gains created only after holding stock.**
- Capital losses cannot be directly netted against ordinary income, even if it comes from a stock sale.
- Exception for down market: When sell ISO and tax-qualified ESPP stock at price lower than purchased, can be all short-term capital loss.

Example:

- ISOs exercise price of \$10
- Exercised when market price is \$12
- Sold in same year at \$6
- No ordinary income, and \$4 in short-term capital loss
- If sell at \$11, \$1 in ordinary income, and no capital loss



Two myths about netting of income with stock options, restricted stock, and ESPPs

Underwater stock options: Negative spread at exercise cannot be netted against income from exercising in-the-money options.

Example:

- 10,000 NQSOs with \$10 exercise price.
- Exercise 5,000 when market price is \$15. Generates \$50,000 in ordinary income.
- Exercising the other 5,000 when market price is \$5 does not generate \$50,000 in ordinary income loss.
- If sold the stock from the second exercise at that point, would have \$50,000 in short-term capital loss. These different types of taxable “income” do not net each other out directly.



4. Wash sale rule: selling stock at loss

- You think company stock is going to bounce back or go higher: be **careful about quickly repurchasing company stock sold at loss** (could buy another stock in same industry).
- If you sell company shares for a loss and buy more company shares within 30 calendar days before or after the loss transaction:
 - the federal tax code will at least temporarily deny you the ability to claim your loss on the sale for the number of shares replaced.
 - loss will be carried over to increase the tax basis of the replacement shares.



4. Wash sale rule

- **Example:**
 - 100 shares of company stock vested at \$20 per share
 - sold at \$10 per share
- The IRS will not allow you to deduct the \$1,000 loss if you purchase, for example, another 100 shares of company stock for \$12 per share within 30 days of the sale (i.e. before the 31st day).
- Instead, you increase the tax basis of the replacement shares by \$1,000 (\$10 each) and pay less tax on the replacement shares when you sell them.
- No **wash sale rule** when you sell for a gain. *Year-end selling at a gain because of higher tax rates ahead does not implicate wash sale rule!*



5. ISO exercise/hold earlier in year but stock price dropped

- It is important to calculate whether you should sell the stock this year to eliminate any alternative minimum tax (AMT) on the spread at exercise.
- **Not doing this analysis near the end of the year**, especially after swings in performance of the stock market in 2011, is a **big mistake** that many people with ISOs make: generating taxes on gains you may never see. AMT credit takes time to recoup.
- In a “disqualifying disposition” the amount of ordinary income and any short-term capital gain (or loss) depends on stock price at exercise and at sale. On myStockOptions.com, look in the section **ISOs: Taxes** for examples.
- If you decide to sell the stock, to avoid problems with the wash sale rule as applied to ISOs (it’s even worse), do not repurchase company shares within 30 days after the sale.
- Other year-end AMT/ISO strategies: Exercising NQSOs to bump up ordinary income; exercising ISOs and holding up your AMT cushion.



6. Exercise and vesting dates near year-end

- Look at stock plan documents for last business day in year when stock options and SARs can be exercised.
- All exercises with an exercise date in 2011, and all restricted stock with a vesting date in 2011, will be included in 2011 taxes and on W-2 for 2011, and will count towards your Social Security income limit in 2011. It does not matter that your company will not send the taxes to the IRS until 2012.
- Stock transfer for gifts and donations need to be completed and received by December 31. Just approving transfer is not enough.



7. Sale of tax-qualified ESPP stock when price drops substantially and then sharply rises

- ESPP with a lookback feature can be a good deal even in a down or volatile market: discount off the lower of either the start-date price or the purchase-date price.

Example: Start-date price \$20, purchase-date price \$10. The 15% discount results in \$8.50 purchase price.

- Satisfy the ESPP holding-period requirements: still ordinary income for the portion of the gain equal to your company's discount (e.g. 5%, 10%, or 15%) from the offering/start-date price, *regardless of the actual purchase price for the stock and no lookback.*
- Ordinary income is this amount of the actual gain at sale, whichever is less. When sold at a loss, no ordinary income and just capital loss.
- Disqualifying disposition (sale immediately or within one year): *only the spread at exercise* is ordinary income.



7. Sale of tax-qualified ESPP stock when price highly volatile

Offering start price **\$20**, purchase-date price **\$10**. The 15% discount results in **\$8.50** purchase price.

Breakdown of ordinary income/capital gains can vary regardless of lookback with a tax-qualified ESPP.

Usually better to have capital gains than ordinary income because you can net gains against losses.

Example with sale when stock price at \$15: Hold long enough: have \$3 in ordinary income and \$3.50 in capital gain. Sell sooner: have \$1.50 in ordinary income and \$5 in capital gain.

Example with sale when stock price at \$5: If wait to sell stock one year after it drops to \$5, will have \$3.50 short-term capital loss and no ordinary income (when loss greater than ordinary income, all capital loss). If sell before one year, will have \$1.50 in ordinary income and \$5 in short-term capital loss.

Taxation with qualified/Section 423 taxation is confusing.

See the section **[ESPPs: Taxes Advanced](#)** on myStockOptions.com.

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Matt Simon

When you consider year-end planning, don't forget to review ESPP shares you may hold. Below we outline issues and strategies to think about. Of course, each scenario and its strategy will vary according to your own circumstances and the outlook for your company's stock price. The end of the year can also be a time to decide about [ESPP enrollment](#) in the new year and the amount of your salary to contribute for share purchases.

The [2010 Tax Relief Act](#), the result of a much-discussed compromise between President Obama and Congress, was enacted in December 2010. It extended the 2010 tax rates through 2012. Given the current political stalemate in Congress and the presidential election ahead in 2012, it is unlikely that tax rates will change in 2012. This should simplify your financial planning at the end of 2011. Unless you were already definitely planning to sell company shares soon, many experts say that tax rates should *not* be the only reason for selling at the end of the year.

The end of the year can be a good time to decide about ESPP enrollment in the new year and the amount of your salary to contribute for share purchases.

Editor's Note: See also related articles on year-end planning with [stock options and company stock](#) and [restricted stock/RSUs](#).

If You Purchased ESPP Shares This Year

Once you have enrolled in your ESPP, it's important to follow your company's stock price in relation to your purchase price. As explained in the next section, the tax treatment (i.e. ordinary income vs. capital gains/losses) can vary depending on when you sell the ESPP shares and how that sales price compares to your purchase price. If you did not quickly sell the shares immediately after purchase, which would result in taxes at your ordinary income rate on any purchase discount, most strategies involve determining how long to hold the



8. Gifts of company stock

- When the stock price is low, this can be good time to transfer stock as gifts to relatives. Consider GRATs when stock price and interest rates low. Not usually good idea to donate stock when price is down.
- The amount of the gift tax exemption for 2011 is \$13,000 per recipient, or \$26,000 per recipient if you split the gift with a spouse. If you expect relatives (such as elderly parents with low incomes) to sell the stock after gifting, they may want to do so before the end of 2012. In 2011, the long-term capital gains rate for people in the 10% and 15% tax brackets for ordinary income is 0%.
- The kiddie tax makes it difficult to take advantage of this 0% rate, though planning ideas exist: see article series on college funding in the **Life Events** section of myStockOptions.com.
- Senior executives making gifts of stock must review the reporting requirements and rules of Section 16 and Rule 144.



9. Refundable AMT credit

- Old AMT credits from ISO exercise/hold are refundable.
- Law passed in 2006; amended in 2007 and again in 2008 as part of financial rescue bill.
- The catch: need to be more than three years old (from 2007 or earlier for tax year 2011).
- 50% of AMT credits refundable per year through 2012. No income phaseouts.
- Without an extension of the provision, *this refundable credit will not be available for AMT credits created in 2010 or later*, as they will not become eligible before the current term of the provision expires.
- Important to know at year-end if this special credit is available to you.




10. High net worth/executive topics

- Hedging of company stock. Find out company policy and whether any prohibition. Dodd-Frank bill has new disclosure requirements.
- Deadline for 409A/nonqualified deferred compensation (NQDC) elections. Applies to RSUs with deferral election and certain performance-based stock plans.
- Elections needed by year-end for income that would be received in 2012. New website on nonqualified deferred compensation at www.myNQDC.com.
- Rule 10b5-1 plans in place when executives know they plan to sell at year end.

FAQ on year-end planning and taxes. For a copy to distribute, email: editors@myStockOptions.com

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 **UPDATED FOR 2011!** What are some year-end strategies for restricted stock and stock options? [msos+](#)

 Decisions in year-end financial and tax planning depend on:

- your financial situation
- whether your decisions should be entirely tax-driven
- what you did earlier in the year
- your outlook for your company's stock price
- the prospects for changes in tax law during the years ahead

Unless you were already definitely planning to sell company stock or exercise options soon, most [experts](#) feel that unease about higher tax rates in the future should not be the only reason for doing so at the end of the year.

The [2010 Tax Relief Act](#), the result of a much-discussed compromise between President Obama and Congress, was enacted in December 2010. It extended the 2010 tax rates through 2012. Given the current political stalemate in Congress and the presidential election ahead in 2012, it is unlikely that tax rates will change in 2012. This should simplify your financial planning at the end of 2011.

Below we present several situations and some strategies that many experts suggest. Of course, you should consult a financial advisor about your individual situation. Note that most of the discussion about stock options also applies to [stock appreciation rights](#).

1. You are planning to sell the stock at exercise late this year or early next year. You should calculate whether the ordinary income at exercise will push you into a higher tax bracket, and what the taxes will be if the rate for that bracket goes up. To break up the tax hit, you may want to spread the same-day exercise/sale over the end of this year and the beginning of next year.

Alert: When you do sell your company stock, reporting it on your tax return raises other issues and pitfalls. See the special section [Reporting](#)

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