Incentive Stock Options: An Overview
After reading this overview, see our ISO content section for more detailed coverage.
ISOs

ISOs

Incentive stock options carry great potential tax benefits, but their taxation can be complex, especially when the alternative minimum tax comes into play. Browse an overview of this section below, or explore the subtopics to the left. See also the ISO sections of the Tax Center.

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Want to know more? Got 6 minutes?
Listen to our podcast on the basics of stock options.

How To Report Sales Of Company Stock On Your Tax Return

The myStockOptions.com Tax Team

Learn how to report sales of stock on your tax return. Annotated diagrams of Form 8949 and Schedule D help you make sense of the reporting rules.
What is an incentive stock option?

- An incentive stock option (ISO) is a specific type of stock option that qualifies for special tax treatment under the Internal Revenue Code if the grant meets certain requirements.
- ISOs are not granted by all companies and can be granted only to employees, not to outside directors, consultants, or contractors.
- There is a $100,000 limit on the aggregate grant value of ISOs that may first become exercisable (i.e. vest) in any calendar year.
Special tax features

- After you exercise ISOs, if you hold the stock for more than two years from the date of grant and one year from the date of exercise, you receive favorable long-term capital gains tax treatment for all appreciation over the exercise price.

- Failing to meet the ISO holding period results in a “disqualifying disposition”—i.e. the early sale disqualifies the ISOs from this special tax treatment. In that case, they are taxed somewhat (but not exactly) like nonqualified stock options.

- ISO exercises can trigger the alternative minimum tax (AMT).
How do ISOs work?

- In general, a stock option is a stock-purchase right a company grants to an individual under the terms of a stock plan and grant agreement.
- You can exercise ISOs to buy a specific number of shares of company stock at a set price during a specified period.
How do ISOs work?

- ISOs cannot be exercised until the vesting period provided under the grant terms has elapsed.
- ISOs expire at the end of the term (e.g. ten years from the grant date) provided in the stock plan and grant agreement. After expiration, they cannot be exercised.
- Job termination stops vesting. Rules may vary in some situations, such as death, disability, or retirement, depending on the specifics of your plan and grant agreement.
- To retain tax benefits, ISOs must be exercised within three months of the termination date.
How do ISOs work?

- After the vesting period has elapsed, you can exercise the ISOs.
- To generate income at exercise, the market price of the stock on the exercise date must be higher than the exercise price of the ISOs.
- Exercise income is called “the spread.”
How do ISOs work?

- After acquiring company shares at exercise, you own them in the way of any other shareholder. You can sell, gift, pledge, or hold the shares.
- When you sell the shares, the tax treatment depends on how long you have held the shares and on the stock price at sale relative to the stock price at exercise.
Types of vesting period

- Typically, a vesting schedule is time-based: you must work at the company for a certain period before vesting.

- The schedule can also, or instead, be performance-based or tied to company-specific or stock-market targets. (Not common with stock options.)

- Vesting schedules provide for either "cliff" vesting (the whole grant vests after you complete a stated service period) or "graded" vesting (e.g. 25% of the grant vests each year for four years).
Exercise methods

- Cash
- Stock you already own (a stock swap)
- Cashless same-day sale
- Sell-to-cover exercise
- Promissory note
- Net options exercise
Cash exercise

- The simplest exercise method is the use of cash to pay the exercise cost.

**Example:** You have ISOs to purchase 100 shares of your company's stock at an exercise price of $10 per share. When the stock reaches $15 per share, you exercise your entire option using cash. To complete the exercise, you write a check to the company for the exercise price of $1,000.
A cashless exercise is an exercise-and-sell transaction in which you do not have to supply the cash needed to pay the exercise price and the amount required for tax-withholding. Instead, you simultaneously exercise your option and sell the stock.

**Example:** You have 10,000 ISOs with a $15 exercise price. You need $150,000 for the exercise cost. The market price is $25, giving you a spread of $100,000 \([($25 - $15) \times 10,000]\).

- **Proceeds needed from exercise and sale:** $150,000 at exercise to cover the exercise cost ($150,000) paid to your company, and commission ($500) for the stock sold.
- **Proceeds from sale:** $250,000 \((25 \times 10,000\) shares). 
- **Proceeds you receive from cashless exercise:** $100,000 \((250,000 - 150,000)\).
- You pay taxes either with your annual return or through quarterly estimated tax payments.
A sell-to-cover exercise is a type of cashless exercise in which the broker sells just enough of the shares from your exercise to pay the exercise price, any tax withholding, and the broker's transaction fees. You receive the remaining shares.

**Example:** You have 10,000 ISOs with a $15 exercise price. You need $150,000 to cover the exercise cost. The market price is $25, giving you a spread of $100,000 [($25 – $15) x 10,000]. The brokerage commission is $500. *Proceeds needed at exercise:* $150,500 at exercise to cover the exercise cost ($150,000) and commission ($500).

- **Shares sold in sell-to-cover exercise:** 6,020 ($150,500 divided by $25).
- **Shares you keep from exercise:** 3,980 (before subtracting any broker's fee for the transaction).
A stock swap, or stock–for–stock exercise, is a stock option exercise in which the exercise price is paid with shares of company stock you own. See the FAQ on stock swaps, as special issues apply to ISOs.

Some companies use a “net options” exercise, in which you return or surrender to the company some of the stock options with a spread value that covers the total cost of exercising and holding. The number of shares you receive will equal the value of your exercise spread.
ISO taxes: five key points

1. Hold shares two years from grant and one year from exercise: full gain over exercise price at capital gains rate. **Qualifying disposition.**
2. If shares not held for that long, then spread at exercise is ordinary income, assuming stock price increased. (When it has not, taxes vary.)
3. No tax withholding or Social Security/Medicare tax, even upon early sale.
4. If shares are held through the year of exercise, the spread at exercise is part of AMT income.
5. AMT credit calculation in future years.
ISO taxation at exercise

- ISO taxation is complex. The tax impact depends on when you sell or transfer the stock.
- If you make a disqualifying disposition (e.g. sale or gift) of ISO shares, ordinary compensation income and any capital gains/losses can vary according to the relationship between your exercise price, the market price at exercise, and the sale price.
- With ISOs, you have no withholding at all, not even Social Security or Medicare tax, at exercise or later sale.
- When you hold the shares long enough in a qualifying disposition, all the gain over the exercise price is capital gain.
- The spread on exercise of an ISO may trigger alternative minimum tax (AMT) when you hold the stock through the calendar year of exercise. AMT is a significant factor to consider in your tax planning for ISOs.
**Stock options: ISO taxes**

**Example:**

Exercise 2,000 options with exercise price of $15 when market price $20. Hold one year from exercise/two from grant. Sell when price $20.

- $10,000 ($5 x 2,000) in capital gain income (was also part of AMT income in year of exercise and holding)
- $1500 in federal capital gains tax (assume 15%), plus state taxes.
- No Social Security, Medicare, or ordinary income tax.
ISO disqualifying disposition: no AMT, but taxes depend on sales price

1. Your sales price is lower than the market price on the exercise date (but is still above the exercise price). The amount between the exercise price and the sales price is compensation income. You have no capital gain or loss. Your basis equals your selling price.

2. You sell at a price higher than the price of the shares on your exercise date. The spread between the exercise price and the stock price on the date of exercise is compensation income. The sales amount over the exercise-day stock price you report as short-term capital gain.

3. You sell the stock for less than your exercise price. The compensation income is zero. You also have a short-term capital loss.
Example: Options at $15 per share you exercised this year when the market price was $55 per share. You thought about selling the stock this year when the price was $115, regret not selling it at $40, and now decide to sell it at $10.

- If you had sold at $115, you would have had $40 in ordinary income ($55 minus $15) and $60 in short-term capital gain ($115 minus $55).
- If you had sold at $40, you would have had $25 in ordinary income ($40 minus $15) and no capital gain.
- When you sell at $10, you have no ordinary income but a $5 short-term capital loss ($10 minus $15).
Alternative minimum tax (AMT)

- The AMT system is complicated. Broadly, it starts by taking your adjusted gross income, subtracts your itemized deductions, makes certain negative and positive adjustments, and includes certain tax items called tax "preferences." The resulting amount is your "alternative minimum taxable income" (AMTI).
- The spread at exercise of an ISO is a positive adjustment for AMT purposes when you continue to hold the ISO stock through the calendar year of exercise.
After AMTI is determined, it is reduced by an exemption amount. This AMT income exemption replaces the personal exemption and standard deduction from the regular-tax system. It is indexed yearly for inflation.

The AMTI exemption amount is phased out for high-income individuals by 25 cents for every dollar of AMTI over specified thresholds.

See an FAQ for the specific current exemption amounts and phaseout thresholds.
The net amount of AMTI is multiplied by the AMT rate to obtain the amount of AMT you owe. The rate is either 26% or 28%, depending on the amount of AMTI.

**Alert:** Don't be fooled if the AMT rates (26% and 28%) are lower than the rates of your regular tax bracket. Your AMT taxable income is often much higher because of the differences in how AMTI and regular taxable income are calculated.

Your effective AMT rate is higher if your exemption amount is phased out.

The calculations are further complicated if you had any capital gains during the year, because capital gains are taxed at 15% under AMT, not 26% or 28%.
For AMT purposes, you must always complete IRS Form 6251 after you have exercised ISOs and held the shares through calendar year of exercise (this is not reported on Form W–2).

Once AMT is triggered, you must complete the form every year, along with Form 8801, which relates to the AMT credit.

You must file Form 8949 and Schedule D with your federal Form 1040 tax return for any tax year in which you have sold shares.

Form 3921, which your company sends you in the January after a year of ISO exercise, has information that can help you with the tax–return reporting.
In our Tax Center, detailed FAQs with annotated diagrams explain all aspects of ISO tax return reporting.

FAQ Subsections:
- NQSO Stock
- ISO Stock
- Restricted Stock, RSUs, and Performance Awards
- SARs Stock
- ESPP Stock

ISO STOCK

ISO: Sale in qualifying disposition

Sales and Other Dispositions of Capital Assets

Form 8949 2019

Sales and Other Dispositions of Capital Assets

Section 83(b) of the Code provides that if a participant acquires shares of stock in a corporation as compensation for services rendered, the participant will be treated as having received a payment in respect of the services rendered at the time of the transfer of the shares to the participant. For this purpose, the amount treated as received will be the fair market value of the shares at the time of the transfer. The fair market value of the shares will be determined by the tax payer using any method that is reasonable and consistent with the method used in determining the basis of the shares. The tax payer must keep records to support the method used to determine the fair market value of the shares.

The taxable income from the sale of capital assets includes any gain or loss on the sale of a capital asset. The tax payer must report the gain or loss on the sale of capital assets on Form 8949, Capital Gains and Losses, and any gain or loss on the sale of capital assets in excess of 

- Long-term assets reported on Form 1040-B showing basis was not reported to the IRS
- Long-term transactions reported on Form 1040-B showing basis was reported to the IRS
- Long-term transactions not reported to you on Form 1040-B

The basis in Box 1 of 1099-B is correct.

Column (a): Basis in Box 1 of 1099-B
Column (b): Leave blank
Column (c): Leave blank

If Box E is checked,

Column (a): Correct basis of the sold shares. Tax basis in a quasilong-term disposition is the fair market value at the time of sale (Box 3 and 1099-B).

If the basis is blank in E,

Column (a): Leave blank
Column (b): Leave blank

On Form 1099-B, If Box E is checked, the basis in Box 1 of 1099-B is correct. Column (a): Basis in Box 1 of 1099-B
Column (b): Leave blank
Column (c): Leave blank

If Box E is checked,

Column (a): Correct basis of the sold shares. Tax basis in a quasilong-term disposition is the fair market value at the time of sale (Box 3 and 1099-B).

If the basis is blank in E,

Column (a): Leave blank
Column (b): Leave blank

On Form 1099-B, If Box E is checked, the basis in Box 1 of 1099-B is correct. Column (a): Basis in Box 1 of 1099-B
Column (b): Leave blank
Column (c): Leave blank

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Column (b): Leave blank
Column (c): Leave blank

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If the basis is blank in E,

Column (a): Leave blank
Column (b): Leave blank
Selling ISO stock that triggered AMT

- ISO stock is dual-basis stock. Higher basis for AMT than for ordinary income.
- Your gain or loss in the AMT system and the regular tax system will be different. Once you have sold the stock, avoid paying or calculating more AMT than is required for your ISO stock sale by reporting (as a negative amount) your adjusted gain or loss on line 17 of IRS Form 6251.
- This negative adjustment can reduce the AMT you would otherwise calculate and let you recover more of your AMT credit. The negative adjustment can't be greater than the capital gain for regular-tax purposes plus $3,000.
It can take years to benefit fully from the AMT credit if you are selling at a substantial loss. (Note that the former law providing for refundable AMT credits has expired.)

**Standard use of AMT credit:** In year when you do not trigger AMT, use credit against regular income tax up to amount of what would be your AMT. Does not require you sell the ISO stock.

**Example:**
- Last year you paid $14,000 of AMT over your regular tax because of your ISO exercise and hold.
- This year, your regular tax is $35,000, while your AMT calculation is only $30,000.
- $5,000 of the $14,000 credit is available, and you carry forward $9,000 to be used in future.
For details on the AMT, see our special AMT sections.

ISOs > AMT

Test your knowledge with our NEW ISOs quiz and interactive answer key!

Test your knowledge with our Stock Options quiz and interactive answer key!

Listen to our podcast on the basics of stock options, or watch our videos on core concepts and ISO taxes.

Articles

VIDEO! Incentive Stock Options (ISOs): Taxes
Bruce Brumberg
To make the most of incentive stock options (ISOs), you must understand their tax fundamentals, explained by the editor-in-chief of myStockOptions.com in this engaging video.

Stock Option Fundamentals (Part 5): Incentive Stock Option Taxation & Alternative Minimum Tax
Marilyn Renninger
Learn how and when income from ISOs is subject to taxes, including the alternative minimum tax. You must consider taxes at both

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