

Employee Stock Options: What Happens When You Exercise or Sell?

A client guide to NQSOs, ISOs, AMT, and the forms that often show up at tax time

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The short answer

Stock options can create tax at very different times depending on the type of option. A nonqualified option generally creates W-2 compensation when exercised. An incentive stock option may avoid regular tax at exercise - but exercising and holding the shares can create an Alternative Minimum Tax (AMT) adjustment.

First question: what kind of option do you have?

Feature	Nonqualified Stock Option (NQSO)	Incentive Stock Option (ISO)
At exercise	Bargain element is generally W-2 compensation.	Generally no regular taxable income at exercise.
FICA	Generally applies to the compensation element.	Course states ISO exercise/disposition proceeds are exempt from FICA.
AMT	No ISO-type AMT preference from the option itself.	Exercise-and-hold can create an AMT adjustment.
Basis after exercise	Generally FMV at exercise.	Regular-tax and AMT basis may differ.
Long-term treatment	Normal stock holding-period rules after exercise.	Special ISO holding periods must be satisfied for qualifying treatment.

NQSOs: tax generally arrives at exercise

For a nonqualified stock option, the bargain element is generally the fair market value of the stock on the exercise date minus the option price. That amount is treated as ordinary compensation income and is generally included on the employee's Form W-2.

Simple example

You exercise shares worth \$30,000 and pay an exercise price of \$12,000. The \$18,000 bargain element is generally compensation income. Your basis in the shares is generally the \$30,000 fair market value at exercise.

ISOs: the holding period is the key

For favorable qualifying-disposition treatment, the course requires both of these holding periods:

- More than 1 year after the option is exercised, and
- More than 2 years after the option was granted.

If the requirements are met, the gain or loss is generally capital gain or loss. Selling too soon can cause part of the gain - generally the bargain element - to be treated as ordinary income.

The ISO surprise: AMT before you sell

Watch the exercise-and-hold strategy

If you exercise an ISO and keep the stock, the bargain element - FMV at exercise minus exercise price - can be an AMT adjustment in the year of exercise. That can create tax even though you have not sold the shares and may not have received cash from the transaction.

Because the ISO AMT adjustment is a deferral item, it may also create an AMT credit carryover. Regular-tax basis and AMT basis can differ, so the later sale may require separate regular-tax and AMT calculations.

Forms worth keeping

Form	Why it matters
Form 3921	Reports the exercise of an Incentive Stock Option (ISO).
Form 3922	Reports certain transfers of stock acquired under an Employee Stock Purchase Plan (ESPP).
Form W-2	For NQSOs, the bargain element is generally reported as compensation; the course notes Code V in Box 12.
Form 15620	IRS form for a Section 83(b) election, discussed below.

Restricted stock and Section 83 elections

- Restricted stock is generally taxed when it is no longer subject to a substantial risk of forfeiture or becomes transferable.
- A Section 83(b) election can accelerate compensation income to the time the property is transferred. The course states the election generally must be filed within 30 days after transfer.
- Section 83(i) may allow certain qualified employees to defer income on qualifying employer stock, potentially for up to five years, subject to earlier triggering events.
- If a Section 83(i) election applies to stock attributable to an ISO, the option is no longer treated as a statutory ISO and the normal ISO preferential rules do not apply.

Before you exercise or sell

- Identify whether the award is an NQSO, ISO, restricted stock, RSU, or ESPP stock.
- Keep the grant notice, exercise confirmation, Forms 3921/3922, W-2, and brokerage statements together.
- For an ISO exercise, record the exercise price and the fair market value on the exercise date.
- Before a large ISO exercise-and-hold transaction, consider the possible AMT cost before committing the cash.
- When shares are sold, make sure basis is not understated if compensation income was already included on the W-2.

Lenny's Take

The tax problem with stock compensation is often not the rate - it is timing and recordkeeping. A transaction that looks simple on a brokerage statement may have already created W-2 income, may have a different AMT basis, or may be subject to a special holding period. Bring the grant, exercise, W-2, and sale documents together before the return is prepared.

General information only. Tax rules depend on individual facts and can change. This guide is not a substitute for advice based on your specific circumstances.