# Incentive Stock Options

What are Incentive Stock Options?

A stock option grants you the right to purchase a certain number of shares of stock at an established price. There are two types of stock options—Incentive Stock Options and Nonqualified Stock Options (ISOs)—and they are treated very differently for tax purposes. In most cases, Incentive Stock Options provide more favorable tax treatment than Nonqualified Stock Options.

If you have been granted stock options, make sure you know which type of options you received. If you are not sure, take a look at your option agreement or ask your employer. The type of options should be clearly identified in the agreement.

Why are Incentive Stock Options more favorable tax-wise?

When you exercise Incentive Stock Options, you buy the stock at a pre-established price, which could be well below actual market value. The advantage of an ISO is you do not have to report income when you receive a stock option grant or when you exercise that option. You report the taxable income only when you *sell* the stock. And, depending on how long you own the stock, that income could be taxed at capital gain rates of 15 percent or less (for sales in 2011)—a lot lower than your regular income tax rate.

With ISOs, your taxes depend on the dates of the transactions (that is, when you exercise the options to buy the stock and when you sell the stock). The price break between the grant price you pay and the fair market value on the day you exercise the options to buy the stock is known as the *bargain element*.

There is a catch with Incentive Stock Options, however: you do have to report that bargain element as taxable compensation for Alternative Minimum Tax (AMT) purposes in the year you exercise the options (unless you sell the stock in the same year). We'll explain more about the AMT later.

With Nonqualified Stock Options, you must report the price break as taxable compensation in the year you exercise your options, and it's taxed at your regular income tax rate, which in 2011 can range from 10 percent to 35 percent.

How transactions affect your taxes

Incentive Stock Option transactions fall into five possible categories, each of which may get taxed a little differently. With an ISO, you can:

1. Exercise your option to purchase the shares and hold them.
2. Exercise your option to purchase the shares, then sell them any time within the same year.
3. Exercise your option to purchase the shares and sell them after less than 12 months, but during the following calendar year.
4. Sell shares at least one year and a day after you purchased them, but less than two years since your original grant date.
5. Sell shares at least one year and a day after you purchased them, and at least two years since the original grant date.

Each transaction has different tax implications. The first and last are the most favorable. The time at which you sell determines how the proceeds are taxed.

If you can wait at least a year and a day after you purchase the stocks, and at least two years after you were granted the option to sell the stocks (as described in item 5 above), any profit on the sale is treated as a long-term capital gain, so it is taxed at a lower rate than your regular income. (Your profit is the difference between the bargain price you pay for the stock, and the market price that you sell it for.) This is the most favorable tax treatment because long-term capital gains recognized in 2011 are taxed at a maximum 15 percent (or 0 percent if you're in the 10 percent or 15 percent income tax brackets) compared to ordinary income tax rates which may be as high as 35 percent. After 2011, tax rates may change depending on what Congress does.

Sales that meet these one- and two-year time limits are called "qualifying dispositions," because they qualify for favorable tax treatment. No compensation is reported to you on your Form W-2, so you do not have to pay taxes on the transaction as ordinary income at your regular tax rate. Category 5 is also a qualifying disposition.

Now if you sell the shares before they meet the criteria for favorable capital gains treatment, the sales are considered "disqualifying dispositions," and you may end up paying taxes on part of the proceeds of the sale at your ordinary income tax rate, which in 2011 could be as high as 35 percent.

When you sell the stock two years or less from the offering date, known as the "grant date," the transaction is a disqualifying disposition. Or if you sell the shares one year or less from the "exercise date," which is when you purchase the stock, that is also considered a disqualifying disposition. In both cases, the compensation should be reported on your Form W-2. The amount reported is the bargain element, which is the difference between what you paid for the stock and its fair market value on the day you bought it. But if your bargain element is more than your actual gain from the sale of the stock, then you report as compensation the amount of the actual gain. The reported compensation is taxed as ordinary income. (Categories 2, 3 and 4 noted above are disqualifying dispositions.)

1. Exercise your option to purchase the shares and hold them

|  |  |
| --- | --- |
| Grant date | 12/31/2010 |
| Exercise date | 6/30/2011 |
| Exercise price | $25 |
| Sale date | Not sold yet |
| Market price on 6/30/2011 | $45 |
| Number of shares | 100 |
| Bargain element | $2,000 |

You do not report anything on your 2011 Schedule D (Capital Gains and Losses) because you have not yet sold the stock. Your employer will not include any compensation related to your options on your 2011 Form W-2 either.

But you will have to make an adjustment for the Alternative Minimum Tax (AMT) that equals the bargain element, which is $2,000 ($45 - $25 = $20 x 100 shares = $2,000). Report this amount on your 2011 Form 6251: Alternative Minimum Tax, line 14.

2. Exercise your option to purchase the shares, and then sell those shares within the same calendar year

|  |  |
| --- | --- |
| Grant date | 12/31/2010 |
| Exercise date | 06/30/2011 |
| Exercise price | $20 |
| Sale date | 06/30/2011 |
| Sale price | $45 |
| Number of shares | 100 |
| Bargain element | $2,500 |

The bargain element is the difference between the exercise price and the market price on the day you exercised the options and purchased the stock ($45 - $20 = $25 x 100 shares = $2,500). This amount should already be included in the total wages reported in Box 1 of your 2011 Form W-2 because this is a disqualifying sale (meaning you are disqualified from taking it as a capital gain and being taxed at the lower capital gains rate because you sold the shares less than a year after exercising the option). If this amount is not included in Box 1 of Form W-2, add it to the amount you're reporting on your 2011 Form 1040, line 7.

Report the sale on your 2011 Schedule D, Part I as a short-term sale. The sale is short-term because not more than one year passed between the date you acquired the actual stock and the date you sold it. For reporting purposes on Schedule D:

* The date acquired is 6/30/2011
* The date sold is also 6/30/2011
* The cost basis is $4,500.This is the actual price paid per share times the number of shares ($20 x 100 = $2,000), plus any amounts reported as compensation income on your 2011 tax return ($2,500)
* The sales price is $4,500 ($45 x 100 shares). This should match the gross amount shown on your 2011 Form 1099-B you receive from your broker after the end of the year.

You end up reporting no gain or loss on the stock sale transaction itself, but the $2,500 overall profit will be taxed at your ordinary tax rate. Because you exercised the options and sold the stock in the same year, you do not need to make an adjustment for Alternative Minimum Tax purposes.

3. Sell shares in the next calendar year, but less than 12 months after you purchased them

|  |  |
| --- | --- |
| Grant date | 12/31/2009 |
| Exercise date | 12/31/2010 |
| Exercise price | $20 |
| Market price on 12/31/10 | $45 |
| Sale date | 06/15/2011 |
| Sale price | $30 |
| Number of shares | 100 |
| Bargain element | $2,500 |
| Actual gain from sale | $1,000 |

Unlike the previous example, the compensation is calculated as the lesser of the bargain element or the actual gain from the sale of the stock, because the market price on the day of the sale is less than that on the day you exercised your option.

* The bargain element, that is, the difference between the exercise price and the market price on the day you exercised the options and purchased the stock ($45 - $20 = $25 x 100 shares = $2,500)
* The actual gain on the sale of the stock ($30 - $20 = $10 x 100 shares = $1,000).

In this example, the amount that is considered compensation is limited to $1,000, your actual gain when you sell the shares, even though your bargain element ($2,500) is higher. The $1,000 may be included in the total wages shown in Box 1 of your 2011 Form W-2 from your employer because this is a disqualifying sale, meaning that it does not qualify for treatment as a capital gain (at the lower capital gains rates). If the $1,000 amount is not included in Box 1 of your 2011 Form W-2, you must still add it to the amount you're reporting as compensation income on line 7 of your 2011 Form 1040.

In order to be taxed only on the lesser of the two calculations, ($2,500 vs. $1,000 in our example), the sale cannot be any of the following:

1. A wash sale: if you repurchase shares in the same company (such as through an employee stock purchase plan) within 30 days before or after the sale of the shares obtained from the exercise of the option, some or all of the sale will be considered a wash sale. You will not be allowed to report the lesser calculation as income for shares sold in a wash sale. You must report the full $2,500 as income.
2. A sale to a related party: If you sell the shares to a related party (a member of your family, or a partnership or corporation in which you have more than a 50 percent interest), you must report the full $2,500 as income.
3. A gift: If you gave the stock to an individual or a charity, rather than selling the shares, you must report the full $2,500 as income.

Report the sale on your 2011 Schedule D, Part I, as a short-term sale. It's considered short-term because less than one year passed between the date you acquired the stock and the date you sold it. For reporting purposes on Schedule D:

* The date acquired is 12/31/2010
* The date sold is 6/15/2011
* The sales price is $3,000. This is the price at the date of sale ($30) times the number of shares sold (100). This amount should be reported as the gross amount on the 2011 Form 1099-B that you'll receive from the broker that handled the sale.
* The cost basis is $3,000. This is the actual price paid per share times the number of shares ($20 x 100 = $2,000) plus the compensation amount reported on your 2011 Form 1040 ($1,000).
* The resulting gain is zero.

Because this sale did not occur in the same year as the year you exercised the options, you have to make an adjustment for AMT. When you originally purchased the stock, you should have reported an income adjustment for AMT purposes in that year. Find out if this was the case by looking at Form 6251 (Alternative Minimum Tax) for the year that you purchased the shares. In our example, the amount that should have been reported on your 2011 Form 6251 was the bargain element ($45 - $20 = $25) times the number of shares (100), which equals $2,500.

So what do you do in 2011? We explain what you need to do in our section on [Reporting an Incentive Stock Option Adjustment for the Alternative Minimum Tax](http://turbotax.intuit.com/tax-tools/tax-tips/Investments-and-Taxes/Incentive-Stock-Options/INF12049.html#reporting).

4. Sell shares at least one year and a day after you purchase, but less than two years after the grant date

|  |  |
| --- | --- |
| Grant date | 08/01/2009 |
| Exercise date | 02/01/2010 |
| Grant price | $20 |
| Market price on 02/01/2010 | $45 |
| Sale date | 06/15/2011 |
| Sale price | $85 |
| Commissions paid at sale | $10 |
| Number of shares | 100 |
| Bargain element | $2,500 |
| Net gain | $3,990 |

The bargain element is calculated as the difference between the exercise price and the market price on the day you exercised the options and purchased the stock ($45 - $20 = $25 x 100 shares = $2,500). This amount should be included in the total wages shown in Box 1 of the 2011 Form W-2 from your employer because this is a disqualifying sale (meaning that your gain does not qualify for capital gains treatment for which the rates are lower than for ordinary income in 2011). If this amount is not included in Box 1 of Form W-2, you still must add it to the amount of compensation income that you report on your 2011 Form 1040, line 7.

You also must report the sale of the stock on your 2011 Schedule D, Part II as a long-term sale. It is long term because more than one year passed between the date you acquired the stock and the date you sold it. For reporting purposes on Schedule D:

* The date acquired is 02/01/2010
* The date sold is 6/15/2011
* The sales price is $8,490. This is the price at the date of sale ($85) times the number of shares sold (100), or $8,500. We then subtract the commissions paid on the sale (in this example $10), resulting in $8,490. This amount should be reported as the gross amount on the 2011 Form 1099-B that you'll receive from the broker that handled the sale.
* The cost basis is $4,500. This is the actual price paid per share times the number of shares ($20 x 100 = $2,000) plus the compensation income reported on your 2011 Form 1040 ($2,500).
* The resulting gain is $3,990 ($8,490 - $4,500 = $3,990).

Because this sale did not occur in the same year as the year you exercised the options, you have to make an adjustment for AMT. When you originally purchased the stock, you should have reported an income adjustment for AMT purposes in that year. Find out if this was the case by looking at Form 6251 (Alternative Minimum Tax) for the year that you purchased the shares. In our example, the amount that should have been reported on your 2011 Form 6251 was the bargain element ($45 - $20 = $25) times the number of shares (100), which equals $2,500. So what do you do this year? You will have to report another adjustment on your 2011 Form 6251. We explain how you calculate your AMT adjustment in the section called [Reporting an Incentive Stock Option Adjustment for the Alternative Minimum Tax](http://turbotax.intuit.com/tax-tools/tax-tips/Investments-and-Taxes/Incentive-Stock-Options/INF12049.html#reporting) below.

5. Sell shares at least one year and a day after you purchase and at least two years after the grant date

|  |  |
| --- | --- |
| Grant date | 01/01/2009 |
| Exercise date | 02/01/2010 |
| Grant price | $20 |
| Market price on 02/01/2010 | $45 |
| Sale date | 06/15/2011 |
| Sale price | $85 |
| Commissions paid at sale | $10 |
| Number of shares | 100 |

This sale is a qualifying sale, because more than two years passed between the grant date and the sale date, and more than one year passed between the exercise date and the sales date. Because this is a qualifying sale, the 2011 Form W-2 you receive from your employer will not report any compensation amount for this sale.

Report the sale on your 2011 Schedule D, Part II as a long-term sale. It is long-term because more than one year passed between the date you acquired the stock and the date you sold it. For reporting purposes on Schedule D:

* The date acquired is 02/01/2010
* The date sold is 06/15/2011
* The sale price is $8,490. This is the price at the date of sale ($85) times the number of shares sold (100), or $8,500. We then subtract any commissions paid on the sale (in this example $10), resulting in $8,490. This amount should be reported as the gross amount on the 2011 Form 1099-B that you'll receive from the broker that handled the sale.
* The cost basis is $2,000. This is the actual price paid per share times the number of shares ($20 x 100 = $2,000).
* The long-term gain is the difference of $6,490 ($8,490 - $2,000 = $6,490).

Because this sale and the exercise of the options didn't occur in the same year, you must make an adjustment for AMT. When you originally purchased the stock, you should have reported an income adjustment for AMT purposes in that year. Find out if this was the case by looking at Form 6251 (Alternative Minimum Tax) for the year that you purchased the shares. In our example, the amount that should have been reported on your 2011 Form 6251 was the bargain element ($45 - $20 = $25) times the number of shares (100), which equals $2,500. So what do you do this year? We'll explain how you calculate your AMT adjustment in the section below.

Reporting an Incentive Stock Option adjustment for the Alternative Minimum Tax

If you buy and hold, you will report the bargain element as income for Alternative Minimum Tax purposes. Report this amount on Form 6251: Alternative Minimum Tax for the year you exercise the ISOs.

And when you sell the stock in a later year, you must report another adjustment on your Form 6251 for the year of sale. But what is the adjustment you should report? The year-of-sale Form 6251 adjustment is added to the stock's cost basis for Alternative Minimum Tax purposes (but not for regular tax purposes).

So, in example 5, rather than using a cost basis of $2,000 for AMT, a cost basis of $4,500 ($2,000 plus $2,500 of the AMT adjustment from the year of exercise) should be used. This results in a $3,990 gain for AMT purposes from the sale, which differs from the regular tax gain of $6,490 by exactly $2,500. This is all pretty complicated and is better left to tax preparation software like TurboTax.

Unused AMT credits

In the year that you exercise an Incentive Stock Option, the difference between the market value of the stock on the exercise date and the exercise price counts as income under the AMT rules, which can trigger an AMT liability. However, you will also generally earn an AMT credit in that year. You can use the credit to lower your tax bill in later years. However, there are limitations on when you can use an AMT credit. In some cases, AMT credits cannot be used for several years. Fortunately, a taxpayer-friendly change in 2008 allows individuals with unused AMT credits  that are over three years old (so-called long-term unused AMT credits) to cash them in.  For the 2011 tax year, long-term unused AMT credits are those that were earned in pre-2007 years. Taxpayers with long-term unused credits from pre-2007 years can generally collect at least half their credit amounts by filing their 2011 returns, and the remainder can be collected by filing their 2012 returns.To figure the  amount of  unused AMT credits that can be collected under this rule,  fill out Form 8801 (Credit for Prior Year Minimum Tax).

Consider the entire picture

It is important to take a look at the whole picture of your capital gains and losses for AMT purposes when you sell stock that you purchased by exercising Incentive Stock Options. If the market turns on you after you have exercised your options and the current value of your stock is now less than what you paid, you could still be subject to the Alternative Minimum Tax. One way around that is to sell the stock in the same year that you bought it, creating a "disqualifying" disposition. That way you will not be subject to the AMT, but you would be subject to regular tax on the difference between your option exercise price and the sales price.

For example, assume you exercised options at $3 a share on a day when the stock was selling for $33, and the stock value later dropped to $25. If you sell the stock at $25 before the end of the year, you would be taxed at ordinary income tax rates on $22 per share ($25-$3) and not be subject to any AMT concerns. But if you hold onto the stock, you would be taxed for AMT purposes in the year you exercised the option on the phantom profit of $30 a share—the difference between your option exercise price and market price on the day you bought the shares--even if the actual market price of your shares fell after that date. It may be advisable to consult with a tax professional prior to making any transactions that involve ISO shares.

TurboTax Premier Edition provides extra help with investments, so you can track and calculate your gains and losses—and TurboTax calculations are [guaranteed accurate](http://turbotax.intuit.com/corp/guarantees.jsp).

A word of caution

Your employer is not required to withhold income tax when you exercise an Incentive Stock Option since there is no tax due (under the regular tax system) until you sell the stock.  Although no tax is withheld when you exercise an ISO, tax may be due later when  you sell the stock, as illustrated by the examples in this article. Be sure to plan for the tax consequences when you consider the consequences of selling the stock.

For additional information, see [IRS Publication 550: Investment Income and Expenses (Including Capital Gains and Losses)](http://www.irs.gov/pub/irs-pdf/p550.pdf) and *Stock Options* in [IRS Publication 525: Taxable and Nontaxable Income](http://www.irs.gov/pub/irs-pdf/p525.pdf).

**Non-Qualified Stock Options**

Updated for Tax Year: 2011

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*Exercising options to buy company stock at below-market price triggers a tax bill. How much tax you pay when you sell the stock depends on when you sell it.*

One way to reward employees

One strategy companies use to reward employees is to give them options to purchase a certain amount of the company’s stock for a fixed price after a defined period of time. The hope is that by the time the employee’s options vest—that is, at the time the employee can actually exercise the options to buy stock at the set price—that the market price of the stock will have risen, so the employee gets the stock for less than the current market price.

If you’re an executive, some of the options you receive from your employer may be Nonqualified Stock Options. These are options that don’t qualify for the more-favorable tax treatment given to Incentive Stock Options. In this article, you’ll learn the tax implications of exercising nonqualified stock options.

Let’s assume that you receive options on stock that is actively traded on an established market such as the NASDAQ, but that the options themselves aren’t traded. The tax catch is that when you exercise the options to purchase stock (but not before), you have taxable income equal to the difference between the stock price set by the option and the market price of the stock. In tax lingo, that's called the **compensation element**.

Compensation element

The compensation element is basically the amount of **discount** you get when you buy the stock at the option exercise price instead of at the current market price. You calculate the compensation element by subtracting the exercise price from the market value.

The **market value** of the stock is the stock price on the day you exercise your options to buy the stock. You can use the average of the high and low prices that the stock trades for on that day.

The **exercise price** is the amount that you can buy the stock for according to your option agreement.

And here’s the kicker: Your company must report the compensation element as an addition to your wages on your Form W-2 in the year you exercise the options. This means the IRS knows all about your windfall, and treats it as, compensation  income, just like your salary. You will owe income tax and Social Security and Medicare taxes on the compensation element.

When do I have to pay taxes on my options?

First things first: You don’t have to pay any tax when you’re **granted** those options. If you are given an option agreement that allows you to purchase 1,000 shares of company stock, you have been **granted** the option to purchase stock. This grant by itself isn’t taxable. It’s only when you actually **exercise** those options and when you later sell the stock that you purchased that you have taxable transactions.

How you report your stock option transactions depends on the type of transaction. Usually, taxable Nonqualified Stock Option transactions fall into four possible categories:

1. You exercise your option to purchase the shares and you hold onto the shares.
2. You exercise your option to purchase the shares, and then you sell the shares the same day.
3. You exercise the option to purchase the shares, then you sell them within a year or less after the day you purchased them.
4. You exercise the option to purchase the shares, then you sell them more than a year after the day you purchased them.

Each of these four scenarios has its own tax issues as the following four tax examples show.

1. You exercise your option to purchase the shares and hold onto them.

In this situation, you exercise your option to purchase the shares but you do not sell the shares.

|  |  |
| --- | --- |
| Exercise date: | 6/30/2010 |
| Exercise price: | $25 |
| Market price on 6/30/2010: | $45 |
| Sales price | N/A (not sold yet) |
| Number of shares: | 100 |

Your compensation element is the difference between the exercise price ($25) and the market price ($45) on the day you exercised the option and purchased the stock, times the number of shares you purchased.

$45 − $25 = $20 x 100 shares = $2,000

$20 × 100 shares = $2,000

Your employer includes the compensation element amount ($2,000) in Box 1 (wages) of your 2010 Form W-2. Why is it reported on your W-2? Because it’s considered “compensation” to you, just like your salary. So even though you haven’t yet seen any actual profit from selling the shares, you’re still taxed on the compensation element just as if you had received a $2000 cash bonus.

What if for some reason the compensation element is not included in Box 1? It’s still considered part of your wages, so you must add it to Form 1040, Line 7 when you fill out your tax return for the year you exercise the option.

2. You exercise your option to purchase the shares and then sell them the same day.

|  |  |
| --- | --- |
| Exercise date: | 6/30/2010 |
| Exercise price: | $25 |
| Market price on 6/30/2010: | $45 |
| Sales price on 6/30/2010: | $45 |
| Commission paid on sale: | $10 |
| Number of shares: | 100 |

As in the previous example, the compensation element is $2,000, and your employer will include $2,000 in income on your 2010 Form W-2.  If they don't,  you must add it to Form 1040, Line 7 when you fill out your 2010 tax return.

Next, you have to report the actual sale of the stock on your 2010 Schedule D, Capital Gains and Losses, Part I.

Because you sold the stock right after you bought it, the sale counts as short-term (that is, you owned the stock for a year or less—less than a day in this case). In this example, the date acquired is 6/30/2010 and the date sold is also 6/30/2010.

Then you have to determine if you have a gain or loss. In this example, the cost basis of your shares is $4,500, and the sales price is $4,490. The $10 (from the commission),is your short-term capital loss. How did we determine these amounts?

1. The **cost basis** is your original cost (the value of the stock, consisting of what you paid, plus the compensation element that you have to report as compensation income on your 2010 Form 1040). The cost basis is therefore, is the actual price paid per share times the number of shares ($25 x 100 = $2,500) plus the $2,000 of compensation reported on your 2010 Form W-2. Therefore, the total cost basis of your stock is $4,500 ($2,500 + $2,000).
2. The **sales price** is the per-share market price on the date of sale ($45) times the number of shares sold (100), which equals $4,500. Then, you subtract any commissions paid for the sale ($10, in this example) to arrive at $4,490 as your final sales price. You’ll probably receive a 2010 Form 1099-B from the broker that handled your option purchase and sale. That form should show $4,490 as your proceeds from the sale.
3. Subtracting your sales price ($4,490) from your cost basis ($4,500), you get a loss of $10.

Remember, you actually came out well ahead (even after taxes) since you sold stock for $4,490 (after paying the $10 commission) that you purchased for only $2,500.

3. You exercise the option to purchase the shares and then sell them within a year or less after the day you purchased them.

|  |  |
| --- | --- |
| Exercise date: | 6/30/2010 |
| Exercise price: | $25 |
| Market price on 6/30/2010: | $45 |
| Sales date: | 12/15/2010 |
| Sales price: | $50 |
| Commission paid at sale: | $10 |
| Number of shares: | 100 |

Again, the compensation element of $2,000 (calculated as in the previous examples) is considered taxable income and should be included in Box 1 of your 2010 Form W-2. If not, you must add it to Form 1040, Line 7 when you fill out your 2010 tax return.

Because you sold the stock, you must report the sale on your 2010 Schedule D.

The stock sale is considered a short-term transaction because you owned the stock less than a year. In this example, the date acquired is 6/30/2010, the date sold is 12/15/2010, the sales price is $4,990, and the cost basis is $4,500. The short term capital gain is the difference of $490 ($4,900-$4,500). How did we get these figures?

* The **sales price** ($4,990) is the market price at the date of sale ($50) times the number of shares sold (100), or $5,000, less any commissions you paid when you sold it ($10). The Form 1099-B from the broker handling your sale should report $4,990 as the proceeds from your sale.
* The **cost basis** is the actual price you paid per share times the number of shares ($25 × 100 = $2,500), plus the compensation element of $2,000 for a total of $4,500. So the gain is $490, the difference between your basis and the sales price, and will be taxed as a short-term capital gain at your ordinary income tax rate.

4. You exercise the option to purchase the shares, then sell them more than a year after the day you purchased them.

|  |  |
| --- | --- |
| Exercise date: | 06/30/2009 |
| Exercise price: | $25 |
| Market price on 6/30/2009 | $45 |
| Sales date: | 12/15/2010 |
| Sales price: | $50 |
| Commission paid at sale: | $10 |
| Number of shares: | 100 |

The compensation element of the $2,000 is the same as in the preceding examples and should have appeared in Box 1 of your W-2 for 2009  (the year you exercised the options to purchase the stock.) Because this transaction occurred in a previous year, you don’t have to pay tax on the compensation element again; it’s now considered part of  your cost basis purchase price for the stock.

You then must report the sale of the stock on your 2010 Schedule D, Part II because it’s  a long-term transaction; you owned the stock for almost 18 months. As in the preceding example, the stock sale gain is $490, calculated in the same manner ($4,990 sale price - $4,500 cost basis). But now the $490 gain is a long-term gain, so you only have to pay tax at the capital-gains rate, which will probably be a lot lower than your regular income-

Things to remember when granted stock options

When you are granted nonqualified stock options, get a copy of the option agreement from your employer and read it carefully.

Your employer is required to withhold payroll taxes on the compensation element, but occasionally that doesn’t happen correctly. In one case we know of, an employee’s payroll department did not withhold federal or state income taxes. He exercised his options by paying $7,000 and sold the stock on the same day for $70,000 then used all the proceeds (plus additional cash) on the deal, to buy an $80,000 car, leaving very little cash on hand. Come tax return time the following year, he was extremely distressed to learn that he owed taxes on the compensation element of $63,000. Don’t let this happen to you.

Employers must report the income from a 2010 exercise of Nonqualified Stock Options in Box 12 of the 2010 Form W-2 using the code “V.” The compensation element is already included in Boxes 1, 3 (if applicable) and 5, but is also reported separately in Box 12 to clearly indicate the amount of compensation arising from an non-qualified stock option exercise.

TurboTax Premier Edition offers extra help with investments and can help you get the best results under the tax law.

For more information, see [IRS Publication 550: Investment Income and Expenses (Including Capital Gains and Losses)](http://www.irs.gov/pub/irs-pdf/p550.pdf) and the Stock Options section in [IRS Publication 525: Taxable and Nontaxable Income](http://www.irs.gov/pub/irs-pdf/p525.pdf).