

# Filing Your Tax Forms After an Exercise of Incentive Stock Options (ISOs)

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## SUMMARY

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As someone who has been granted Incentive Stock Options (ISOs), you should understand the tax consequences when you exercise the option and sell the stock. ISOs receive beneficial tax treatment if the timing of the option exercise and subsequent sale of the acquired stock meet certain requirements.

A qualifying cashless exercise of an ISO is taxed favorably in contrast to a cashless exercise of a non-qualified stock option. Upon the exercise of a non-qualified stock option, the participant receives ordinary income that must be reported on the individual's tax return. This income is treated as additional compensation, and is reported on your Form W-2 (see Exhibit 1). The difference between your exercise price and the fair market value of the stock at the time a non-qualified option is exercised is the amount treated as additional compensation. Morgan Stanley and its affiliates do not provide tax or legal advice. You should, therefore, seek tax advice based on your particular circumstances from an independent tax advisor of your choosing.

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## HIGHLIGHTS

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- Q. Why must I pay additional income tax when I file my annual return?

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- Q. What portion of my ISO exercise is taxable?

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- Q. How does my employer calculate the income I earned on my ISO exercise?

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- Q. Where can I find my cost basis?

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**EXHIBIT 1: W-2 WAGE AND TAX STATEMENT (FOR ILLUSTRATIVE PURPOSES ONLY)**

22222		Void <input type="checkbox"/>	a Employee's social security number		For Official Use Only ▶ OMB No. 1545-0008	
b Employer identification number (EIN)			1 Wages, tips, other compensation		2 Federal income tax withheld	
c Employer's name, address, and ZIP code			3 Social security wages		4 Social security tax withheld	
			5 Medicare wages and tips		6 Medicare tax withheld	
			7 Social security tips		8 Allocated tips	
d Control number			9		10 Dependent care benefits	
e Employee's first name and initial		Last name	Suff.	11 Nonqualified plans		12a See instructions for box 12
f Employee's address and ZIP code			13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>		12b V 2,000	
			14 Other		12c	
					12d	
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** Wage and Tax Statement **2014** Department of the Treasury—Internal Revenue Service  
**Copy A For Social Security Administration** — Send this entire page with Form W-3 to the Social Security Administration; photocopies are **not** acceptable. For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 10134D  
**Do Not Cut, Fold, or Staple Forms on This Page**

The example above is hypothetical and does not reflect the results of an actual sale or transaction.

This guide has been prepared to assist those of you who have made a disqualifying disposition of your ISOs during the past calendar year. There is no requirement to report ordinary income in a manner similar to the way you would if you exercised a non-qualified option, unless upon exercise of an ISO you sell the stock at the same time. In this case, the sale is a disqualifying disposition. A disqualifying disposition requires the spread between the exercise price and fair market value at the time of the exercise be treated as income. However, if you exercise an ISO

and hold the stock long enough to satisfy a special holding period, your gain from the stock sale will be treated as capital gain instead of ordinary income.

A further explanation of holding period requirements is provided below. Be aware that Same-Day-Sale and Sell-to-Cover exercises are generally considered disqualifying dispositions.

In addition, the beneficial tax treatment afforded ISOs may be partially offset by the alternative minimum tax (AMT). Normally, a disqualifying disposition does not have an impact on AMT within the same calendar year.

This is a complex calculation that may cause you to pay tax at the time you exercise an ISO. The exercise of an ISO gives rise to an “adjustment” under the alternative minimum tax. The adjustment, or what is commonly referred to as a preference item, is precisely the amount you would have reported as compensation income if you exercised a non-qualified option instead of an ISO. In other words, it is equal to the amount by which the fair market value of the stock exceeds the amount you paid for it, otherwise known as the spread or the bargain element. AMT must be

**EXHIBIT 2: EXERCISE CONFIRM** (FOR ILLUSTRATIVE PURPOSES ONLY)

# Morgan Stanley

Attn: Morgan Stanley  
 Global Stock Plan Services  
 4343 Easton Commons, Suite 300  
 Columbus, OH 43219

Account Number:  
 Financial Consultant:

JOHN SMITH  
 123 MAIN STREET  
 NEW YORK, NY 10012

Your broker dealer is  
 Morgan Stanley Smith Barney LLC

You sold 100 at a price of 60.00

**EXERCISE AND SELL**  
 Plan # 11 ID 123456789  
 ISO Grant ID 654321  
 Exercise Quantity 100  
 Grant Price 40.00  
 Option Cost 4,000.00  
 Gain @ 60.00 2,000.00  
 Federal Tax 540.00  
 FICA Tax2 29.00  
 State Tax .00  
 Local Tax1 .00  
 Commission 25.00  
 Transaction Fee 4.00  
 \*\*Exercise Fee 10.00  
 Other Fees .01

Gross Amount	\$6,000.00
<u>Total Exercise Cost</u>	<u>\$4,608.01</u>
<b>Net Amount</b>	<b>\$1,391.99</b>
<b>Settlement Date</b>	<b>04/06/14</b>

Trade Date: 04/03/14  
 Market: Over-The-Counter

CUSIP# 298275302  
 Security# F432987  
 Symbol: ABCD

Unsolicited Order  
 Cash Acct  
 Ref#: 0066289

We acted as your agent in this transaction

\*\*If applicable

The example above is hypothetical and does not necessarily reflect the results (including transaction costs) of an actual cashless option exercise and sale.

**EXHIBIT 3: SAMPLE MORGAN STANLEY FORM 1099-B (FOR ILLUSTRATIVE PURPOSES ONLY)**

**Morgan Stanley**

*Ref : 3:49 PM 10/13/14*

JOHN SMITH  
123 ANY STREET  
NEW YORK, NY  
10004

**Forms 1099 for 2014**

Account 528-XXX-XX-4500 SS # XXX-XX-1111

*This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.*

**Form 1099-B Proceeds From Broker and Barter Exchange Transactions** (OMB No.1545-0715)

This section shows your proceeds from security trades and tenders during the year. The gross proceeds from each transaction are reported individually to the IRS after deduction of commissions.

Ref. Number	Description (Box 1a)/ CUSIP Number	Date of Sale or exchange (Box 1c)	Date of acquisition (Box 1b)	Quantity	Covered (Box 3*)/or Noncovered (Box 5**)/ Type of gain or loss (Box 2)	Gross proceeds less commissions (Box 1d)	Cost or other basis (Box 1e)	Adjustments (Box 1g)/ (Box 1f)	Check if loss not allowed based on amount in Box 1d (Box 7)	Federal income tax withheld (Box 4)
66289	ABC Company	04/03/14	04/03/14	100	Covered Short-term	5960.99	4000.00		<input type="checkbox"/>	<input type="checkbox"/>
<b>TOTALS</b>						<b>\$ 5960.99</b>			<input type="checkbox"/>	

\*Consider **Box 3 (Basis Reported to IRS)** as being checked. **Short-Term** transactions should be reported on **Form 8949 Part I** with **box A** checked. **Long-Term** transactions should be reported on **Form 8949 Part II** with **box D** checked.

\*\*Consider **Box 5 (Basis not reported to IRS)** as being checked. **Short-Term** transactions should be reported on **Form 8949 Part I** with **box B** checked. **Long-Term** transactions should be reported on **Form 8949 Part II** with **box E** checked.

The example above is hypothetical and does not reflect the results of an actual sale or transaction.

considered in situations that are not disqualifying dispositions. You may wish to refer to IRS Form 6251 (Alternative Minimum Tax – Individuals). Whether you have made a qualifying or disqualifying disposition of an ISO, or exercised a non-qualified option, it is advisable to discuss your potential tax liability with your tax advisor.

**The information below addresses the tax consequences of a “cashless exercise” of an ISO**

To avoid a disqualifying disposition, you must hold the stock you acquired from

exercising your ISO until the later of:

- One year after the date you exercised the ISO, and within
- Two years after the date your employer granted the ISO to you.

As to shares you sell at the time of exercise, the tax consequences are essentially the same as for the exercise of a non-qualified option. You are required to report compensation income (not capital gain) equal to the bargain element in the exercise of the option. You should not report an AMT adjustment for these shares. In addition, you will report gain or loss, but

usually an amount close to zero, on the sale of the shares.

**Gather together the following items to prepare your tax return**

- Form W-2 sent to you by your employer. This form shows your income earned from salary and other compensation, including employee stock option exercises.
- Form 1099 sent to you by Morgan Stanley. This form shows the proceeds from the sale of shares along with the Cost Basis (see exhibit 3).

**EXHIBIT 4: IRS FORM 8949 SALES AND OTHER DISPOSITIONS OF CAPITAL ASSETS (FOR ILLUSTRATIVE PURPOSES ONLY)**

Form **8949**

Department of the Treasury  
Internal Revenue Service

**Sales and Other Dispositions of Capital Assets**

► Information about Form 8949 and its separate instructions is at [www.irs.gov/form8949](http://www.irs.gov/form8949).

► File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074

**2014**

Attachment  
Sequence No. **12A**

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Name(s) shown on return \_\_\_\_\_ Social security number or taxpayer identification number \_\_\_\_\_

*Most brokers issue their own substitute statement instead of using Form 1099-B. They also may provide basis information (usually your cost) to you on the statement even if it is not reported to the IRS. Before you check Box A, B, or C below, determine whether you received any statement(s) and, if so, the transactions for which basis was reported to the IRS. Brokers are required to report basis to the IRS for most stock you bought in 2011 or later.*

**Part I Short-Term.** Transactions involving capital assets you held one year or less are short term. For long-term transactions, see page 2.

**Note.** You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the total directly on Schedule D, line 1a; you are not required to report these transactions on Form 8949 (see instructions).

**You must check Box A, B, or C below. Check only one box.** If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

(A) Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see Note above)

(B) Short-term transactions reported on Form(s) 1099-B showing basis was not reported to the IRS

(C) Short-term transactions not reported to you on Form 1099-B

1	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the Note below and see Column (e) in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions.		(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
						(f) Code(s) from instructions	(g) Amount of adjustment	
	ABC Company	04/03/14	04/03/14	5960.99	4000.00	B	(2000.00)	(39.01)

Complete appropriate Short-Term or Long-Term section. Check appropriate Box A, B or C, depending on what is provided within either Box 3 or Box 5 on your 1099-B. Sections b, c, d and e should be populated with the amounts from your 1099-B. Section g should include any compensation income associated with the transaction.

The example above is hypothetical and does not reflect the results of an actual sale or transaction.

Morgan Stanley will report the minimum cost basis on the 1099-B, which is the purchase/grant price of the ISO.

- Either your original stock option exercise confirmation form sent to you by Morgan Stanley OR the Year-End Exercise Summary Statement that we mailed you for the tax year. Each confirmation gives details on an individual exercise. The Summary Statement lists all your exercise transactions for a calendar year.
- Form 1040 (not Form 1040EZ or

Form 1040A). This is the IRS form you need to use when you need to provide details on your income.

- IRS Form 8949: Sales and other Dispositions of Capital Assets. This form can be downloaded from the IRS website [www.irs.gov](http://www.irs.gov) or obtained from most US post offices.
- Schedule D of Form 1040. This is the IRS form used to calculate any capital gains or losses. This form can be downloaded from the IRS website [www.irs.gov](http://www.irs.gov) or at obtained from US post offices.

**You need to report the following information regarding a cashless exercise of incentive stock options**

There are two basic pieces of information that are necessary to report on your tax return: The amount of compensation earned by the exercise, if any, and (2) any capital gain or loss realized.

**EXHIBIT 5: IRS FORM 1040 SCHEDULE D CAPITAL GAINS AND LOSSES (FOR ILLUSTRATIVE PURPOSES ONLY)**

<b>SCHEDULE D (Form 1040)</b>		<b>Capital Gains and Losses</b>			OMB No. 1545-0074
Department of the Treasury Internal Revenue Service (99)		▶ Attach to Form 1040 or Form 1040NR. ▶ Information about Schedule D and its separate instructions is at <a href="http://www.irs.gov/scheduled">www.irs.gov/scheduled</a> . ▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.			<b>2014</b> Attachment Sequence No. <b>12</b>
Name(s) shown on return				Your social security number	
<b>Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less</b>					
See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.		(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
<b>1a</b> Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b .					
<b>1b</b> Totals for all transactions reported on Form(s) 8949 with <b>Box A</b> checked . . . . .		5960.99	4000.00	(2000.00)	(39.01)
<b>2</b> Totals for all transactions reported on Form(s) 8949 with <b>Box B</b> checked . . . . .					
<b>3</b> Totals for all transactions reported on Form(s) 8949 with <b>Box C</b> checked . . . . .					

Part I corresponds with Part I of Form 8949. The totals from Form 8949 are to be carried over to Schedule D. The example above is hypothetical and does not reflect the results of an actual sale or transaction.

**Capital gains and/or losses**

Calculate your capital gains and/or losses using the appropriate IRS forms. All capital transactions are reported on Form 8949 Sales and Other Dispositions of Capital Assets (Exhibit 4); the subtotals from this form are then carried over to Schedule D (Exhibit

5), where gain or loss is calculated in aggregate. Morgan Stanley will report the minimum cost basis on Form 1099-B, which is the purchase/grant price of the ISO. Any additional compensation as a result of the transaction must be reported on Form 8949.

## Questions & Answers

### Q. How do I find my stock option exercise income?

**A.** Compensation income resulting from a disqualifying disposition is included in Box 1 of your W-2, along with your salary and other compensation. However, you will need to isolate the amount of income derived from your ISO exercise from your other earned income. Some employers show stock option exercise income separately in either Box 12 or Box 14. If you cannot find it there, you can ask your Payroll Department to tell you the amount of income they reported for your exercise.

### Q. My exercise confirmation shows that payroll taxes were withheld from the proceeds of my disqualifying disposition of stock. Why must I pay additional income tax when I file my annual return?

**A.** Many employers withhold the minimum required withholding percentage mandated by the tax law. This minimum is really only an estimate of your tax due; your actual tax liability is determined when your tax return is prepared. If too much tax was withheld from the disposition, then you will receive a refund from the IRS. If too little tax was withheld, then you must pay the balance due when you file your tax return.

### Q. What portion of my ISO exercise is taxable?

**A.** If the stock sale is a disqualifying disposition, then compensation income equal to the difference between the fair market value of the stock and the exercise price (the “spread”) is taxed at ordinary income rates. On the other hand, if the stock sale is a qualified disposition, then you generally do not need to report any compensation income. However, the spread is a tax preference item that must be taken into account in determining whether or not you are subject to the alternative minimum tax.

Upon the exercise of the ISO, the participant acquires a tax basis in the purchased stock equal to the exercise price plus any compensation income realized on a disqualifying disposition of the stock. The capital gain or loss realized on the subsequent sale of the stock is the difference between the actual sale price of the stock, less any commissions or fees, and the tax basis. The tax basis may exceed the amount realized on the stock sale and a capital loss results. This may occur in a same-day sale because the tax basis equals the actual sale price but transaction fees reduce the gross proceeds from the stock sale. The resulting capital loss would equal the transaction fees.

### Q. How does my employer calculate the income I earned on my ISO exercise?

**A.** Your employer calculates your income earned from the cashless exercise by subtracting your option price (the price you actually paid for the stock) from the fair market value of the stock. This amount is then reported on your Form W-2. There are several ways to determine a stock’s fair market value. Your employer’s method is stated in your Incentive Stock Option Agreement. Some employers use the actual sale price, but others use the closing price on the preceding day or on the sale date. Some companies even use an average price.

### Q. I previously used Form 1040EZ or Form 1040A when I filed. Why must I use a Form 1040 with a Form 8949 and a Schedule D attached this year?

**A.** If you sold stock you got from exercising an employee stock option, then you must use a Form 1040 in order to provide the IRS with the detail it requires. The IRS Form 8949 and the Schedule D show how you arrived at the amount of capital gain or loss that you reported on your Form 1040.

### THE MORGAN STANLEY ADVANTAGE



For nearly 80 years, Morgan Stanley has been a leader, innovator and resource for successful individuals and their families, as well as corporations, foundations and endowments. Our Financial Advisors work from an extensive knowledge base built on diverse skills, experience, training and professional interests. The Global Stock Plan Services unit of Morgan Stanley has over four decades of experience delivering advice and transaction support to stock plan administrators and participants. We are also a market leader in providing financial solutions to meet the specialized needs of executives, including #1 in 10b5-1 plans.\*

\* Source: Washington Service. Morgan Stanley ranked #1 in 10b5-1 market share from 2005 through 2013. Data from the period 2/1/2005 to 5/31/2009 reflects the formerly separate PDP businesses of the Global Wealth Management Group of Morgan Stanley & Co. LLC and the Smith Barney division of Citigroup Global Markets Inc. that now form Morgan Stanley Smith Barney LLC. This data also includes transactions from Morgan Stanley & Co. LLC. Information contained herein was obtained from sources believed reliable but the accuracy and completeness thereof cannot be guaranteed. Information contained herein is subject to change.

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