

Employee stock options

Stock swap exercise strategy



Wealth
Management

A stock swap (purchasing stock with currently-owned company stock) allows an executive to use currently owned company stock as payment of the exercise price. This eliminates the need for cash to exercise the options. However, cash is needed to pay any required tax withholding and pay any increase in the income tax liability due to the imposition of the alternative minimum tax (AMT).

A stock swap is an indirect method of diversifying a concentrated equity position without the imposition of any additional income taxes or capital gains taxes normally paid on the exercise of the option and sale of existing stock. The executive reduces his or her exposure to the company stock by virtue of swapping old shares of company stock for new shares of company stock.

Non-qualified options (NQSO)

Although a stock swap can be used to exercise NQSOs, there are no benefits to a stock swap over a cash-less exercise and there is the potential capital gains tax problem. Shares used to pay the income tax withholding are considered sold and could result in capital gains tax.

Incentive stock options (ISO)

The advantages of using the stock swap method with incentive stock options include:

- No need to use cash for option exercise price
- Forces indirect diversification
- Future stock growth taxed at sale as a capital gain (if held for more than one year); disadvantages of using the stock swap method with incentive stock options include:
 - Possible negative cash flow due to tax liability for AMT
 - Carryover basis for shares swapped in
 - Zero basis for net shares received from swap

Important note:

Shares of company stock acquired from a prior ISO exercise not held for at least one year should not be used in stock swap. Using these shares in this method disqualifies the previous ISO exercise since the one-year holding period has not been met.

Example for ISO exercise

Forty shares of stock are owned outright with a basis of \$10 per share. The current market value of the stock is \$50 per share (total market value of \$2,000). These shares will be swapped to acquire 100 options with an option purchase price of \$20 per share (total exercise cost of \$2,000).

Total exposure to company shares prior to the swap is 140 shares (100 options plus the 40 owned outright). Exercising the options using a stock swap reduces the exposure to 100 shares as the 40 owned were given up to pay for the \$2,000 exercise price. The client owns 100 shares of company stock: 40 shares have a basis of \$10 per share (carryover basis) and the new 60 shares have a \$0 basis. Although exercising options with stock will not change the immediate tax consequences, it may have an effect when the stock is subsequently sold at some time in the future.

Investment and insurance products offered through RBC Wealth Management are not insured by the FDIC or any other federal government agency, are not deposits or other obligations of, or guaranteed by, a bank or any bank affiliate, and are subject to investment risks, including possible loss of the principal amount invested.

RBC Wealth Management does not provide tax or legal advice. All decisions regarding the tax or legal implications of your investments should be made in connection with your independent tax or legal advisor. No information, including but not limited to written materials, provided by RBC WM should be construed as legal, accounting or tax advice.

© 2023 RBC Wealth Management, a division of RBC Capital Markets, LLC, registered investment adviser and Member NYSE/FINRA/SIPC.

23-71-02375_7109 (08/23)