

ISO Grants

Example

Let's say Employee #1 joined Sierra several years ago and received:

- 100,000 ISOs
- Exercise (strike) price: \$2/share
- Previous 409A valuation: \$10/share
- New 409A valuation: \$35/share

She/he has already vested all 100,000 ISOs.

Scenario 1: Exercise and Hold

Suppose Employee #1 exercises when the 409A value was \$10/share

Cost to Exercise

$$10,000 \times \$2 = \$20,000$$

Bargain Element (Spread)

$$10,000 \times (\$10 - \$2) = \$80,000$$

Total net outlay: \$20,000 + AMT cost (let's assume \$5,000) = \$25,000

The spread is not treated as a regular taxable income. However, it may trigger an Alternative Minimum Tax (AMT) adjustment. Be mindful of how this impacts your taxes, so be sure to coordinate with your accountant or financial advisor to determine the potential AMT cost.

Scenario 2: Exercise and Hold

Employee #1 exercises after new 409a valuation at \$35/share

Exercise Cost

$$10,000 \times \$2 = \$20,000$$

Bargain Element (Spread)

$$10,000 \times (\$35 - \$2) = \$330,000$$

Total net outlay: \$20,000 + AMT cost (let's assume \$80,000) = \$100,000

Waiting to exercise can potentially result in higher AMT tax depending on your income and overall tax situation.

Scenario 1: Why Exercise Early

Example:

- Employee #1 exercises at \$10/share (409a valuation 2 years earlier)
- Sierra has a tender offer at \$85/share

Value at Tender offer

$$10,000 \times \$85 = \$850,000$$

Cost basis:

$$10,000 \times \$2 = \$20,000$$

Total Capital gain:

$$\$830,000$$

Capital gains tax liability (assuming FED 20% + CA 13% + NIIT 3.8%):

$$\$305,440$$

Total net outlay = Exercise cost + AMT + tax liability = \$330,440

Estimated Net proceeds = \$519,560

Because she/he met the ISO holding periods, much of that gain can qualify for long-term capital gains treatment rather than ordinary income. Be sure to factor in any AMT costs and check with your advisor about whether you can get a credit for your AMT payments in the year of sale, if applicable

Potential Tax Savings

Without early exercise:

- Much of the gain may be taxed as ordinary income
- Federal rates can approach 37%

With a qualifying ISO disposition:

- Federal long-term capital gains rates are 15-20%. The difference can be hundreds of thousands of dollars.

Scenario 2: Why Exercise Early

Example:

- Employee #1 exercises at \$35/share and a year goes by before the tender offer
- Sierra has a tender offer at \$85/share

Value at Tender offer

$$10,000 \times \$85 = \$850,000$$

Cost basis:

$$10,000 \times \$2 = \$20,000$$

Total gain:

$$\$830,000$$

Capital gains tax liability (assuming FED 20% + CA 13% + NIIT 3.8%):

$$\$305,440$$

Total net outlay = Exercise cost + AMT + tax liability = \$405,440

Estimated Net proceeds = \$444,560

Because she/he met the ISO holding periods, much of that gain can qualify for long-term capital gains treatment rather than ordinary income. Be sure to factor in any AMT costs and check with your advisor about whether you can get a credit for your AMT payments in the year of sale, if applicable

Potential Tax Savings

Without early exercise:

- Much of the gain may be taxed as ordinary income
- Federal rates can approach 37%

With a qualifying ISO disposition:

- Federal long-term capital gains rates are 15-20%. The difference can be hundreds of thousands of dollars.

Two Important Requirements

ISO Holding Period

- Hold shares at least 1 year after exercise
- Hold shares at least 2 years after grant

If both requirements are met:

Future appreciation can qualify for long-term capital gains treatment under a qualifying ISO disposition.