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Upcoming Increases in Top Income Tax and Capital Gain Rates Should Prompt Executives to Review Their Stock Option Strategies

Melville, NY...

On January 1st, 2011, the top income tax and capital gain rates will return to their rates before 2001 when Bush administration legislation reduced them; that is, 39.6% and 20% respectively. That change and its effect should prompt executives and other high earners holding equity compensation such as nonqualified stock to review their holdings and consider an actionable strategy said Charles Massimo, president of CJM Fiscal Management (www.cjmfiscal.com, Melville, NY), an independent wealth management and financial advisory firm.

“Nonqualified stock options allow employees to buy company stock at a preset price, typically for a set period of time, usually not more than ten years and often subject to vesting requirements,” noted Massimo. “Since this stock is regarded as an element of their compensation, it is taxed at ordinary income rates when the options are exercised. Therefore, those employees at the top tax rates such as executives should be considering exercising their options this year before that income is subject to the 39.6% rate in 2011 and thereafter.” Massimo went on to explain how this decision should be made.

“When considering whether or not it makes financial sense to exercise your stock options, individuals must first know the current fair market value of their stock, the expiration term of their stock options, and the cost to exercise the option. Then, applying all of these figures along with the current federal income and FICA taxes, they can arrive at the net value they will derive,” continued Massimo. “The same formula should then be applied using the higher rates which would be applied in year 2011 and thereafter. Then, they can compare the two net values.”

Massimo added that if they elect to exercise their stock options prior to their expiration date, they need to factor in the after-tax growth rate of the replacement investment they select in order to calculate a break-even point between the two strategies (i.e., holding onto the stock or investing the profits in another investment).

“The annual growth rate of the company’s stock is also a factor when deciding whether to hold onto the stock or exercise options and invest the profits,” said Massimo.

“Additionally, there will be different exercise prices and expiration dates for each nonqualified stock option an individual may hold, which need to be evaluated separately using the above calculation formula to determine which options it may make sense to exercise and where no action should be taken.”

Massimo cautioned, “As with any investment strategy, applying sound principles of portfolio diversification, balancing and rebalancing is essential. In the case of exercising options relating to company stock, executives also have a good understanding of how their company is performing and its future growth profile. Clearly, the decision to exercise stock options should be made after evaluating all of these factors and not solely on the basis of rising income and capital gains taxes. Additionally, it should be made within the context of your overall investment and wealth management plan and with the guidance of your accountant, estate planning attorney and financial advisor.”

For more information on this topic, contact: CJM Fiscal Management at: 631-777-1030.