Financial Planning

Understanding Your Employee Stock Options

Over the past several years, many employers have added stock-based compensation to their overall employee compensation packages. The reasoning behind this is that employers want to tie employee performance to the company's success in the hopes that it will align the employee's and employer's goals more closely.

Stock-Based Compensation

Some of the more common forms of stock-based compensation are restricted stock, stock appreciate rights and stock options.

- Restricted stock grants are simply grants of shares of stock that will become available to the employee at a future date. Generally, the value of the restricted stock is not taxable to the employee until the date he or she takes ownership of it on that future date.
- Stock Appreciation Rights (SARs) are cash bonuses based on the appreciation in the company's share price over a period of time. Although SARs are tied to stock price appreciation, the employee does not take ownership of shares of stock at any point under a SAR plan; instead, he or she receives a cash bonus equal to the amount of appreciation in a set number of company shares over a certain period of time. SARs are not taxable to the employee when granted; the employee pays tax on the bonus when it is received.
- Stock Options are another form of stock-based compensation. If you've received stock option grants from your employer, you're not alone. Stock options have become a popular addition to many employee compensation packages.

Because stock options are complex, it's important to get an understanding of what they are, how they work and strategies for exercising them. The following information may help you to understand the basics of employee stock options if your employer has made stock option grants to you. Of course, you should also work with your tax advisor and your financial advisor to determine the best way to handle your stock options. Uninformed decisions and even doing nothing at all can lead to costly mistakes from both a tax and an overall financial perspective.

What is an Employee Stock Option?

An employee stock option is a right to purchase a certain number of shares of the employer's stock at a set price within a certain time frame. The purchase of the stock is known as the "exercise" of the option. The purchase price is interchangeably referred to the "exercise price," "strike price" or "grant price." The time frame in which the option can be exercised is called the "exercise period." The exercise period begins with the "vesting date" and ends on the "expiration date." The time frame from grant date to expiration date is the "option term."

Information on the exercise price and exercise period for any options that have been granted can be found in the employee's grant letter. Additional information on the stock options is included in the stock option plan document. Both the grant letter and the plan document should indicate the type of options that have been granted.

There are two types of stock options: Nonqualified Stock Options (NSOs) and Incentive Stock Options (ISOs). Although some employees may receive a combination of NSOs and ISOs, NSOs are the more common of the two types. The rules for NSOs and ISOs differ and as a result, planning for exercising them will often differ as well.

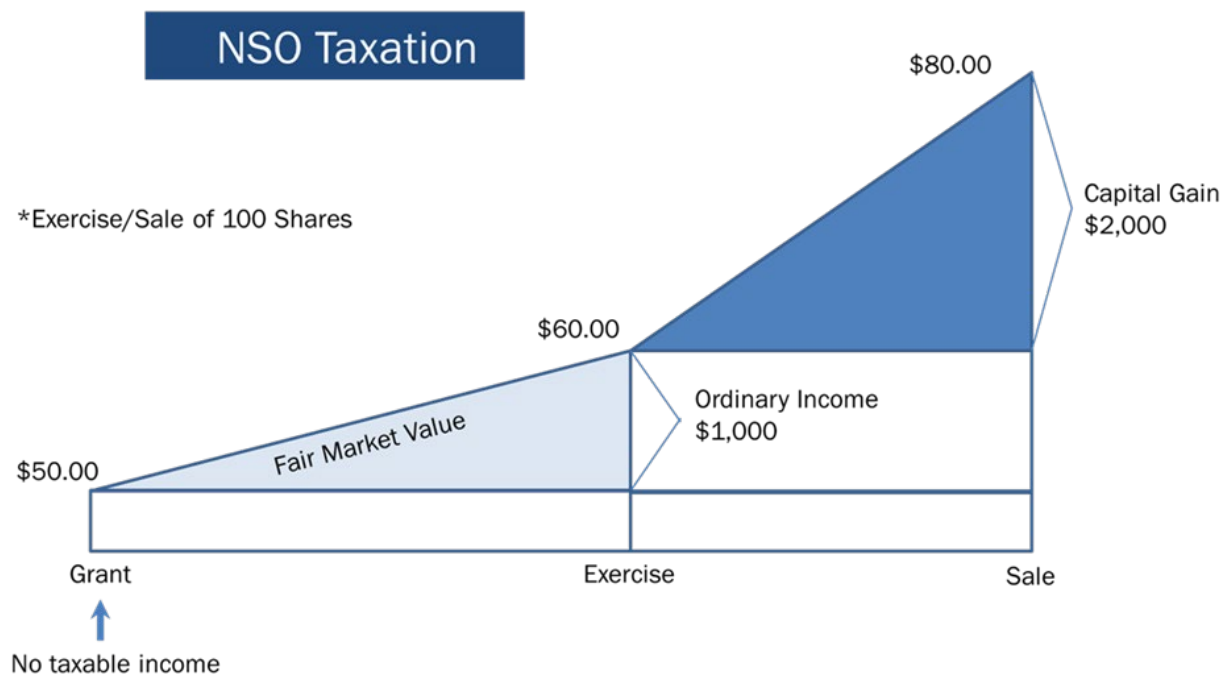
Nonqualified Stock Options (NSOs)

When you receive an NSO grant, there is no taxable event for you. However, when you exercise an NSO, the difference between the exercise price and the stock price on the date of exercise (known as the "spread") is taxable to you as ordinary income. This income is compensation income and will be subject to income taxes as well as Social Security and Medicare taxes.

When you sell the shares, you will pay tax on the gain realized from the sale, which is the selling price minus the cost basis. Your cost basis in the shares purchased through the exercise is the exercise price you paid plus the spread that you included as taxable ordinary income at the time of exercise. The gain will be taxed as a long-term capital gain if you have held the shares for longer than one year. If you've held them for a year or less, the gain will be short-term and will be taxed as ordinary income.

NSO Example - Assume that on January 1, 2010, you are granted NSOs to purchase 100 shares of ABC stock at $50 a share. You exercise the options on July 1, 2011, when the price of ABC stock is $60 a share. You then hold the shares you've purchased until August 1, 2012, when you sell them for $80 a share.

When you are granted the NSOs on January 1, 2010, there is no taxable income to you. On July 1, 2011, you pay $5,000 to purchase 100 shares ($50 a share). Since the value of the shares is $6,000 ($60 a share), the spread of $1,000 ($6,000 - $5,000) is taxable to you as ordinary income in 2011. When you sell the shares on August 1, 2012, you receive $8,000 ($80 a share) and your cost basis is $6,000. The difference of $2,000 is a long-term capital gain because you've held the shares for over a year.



Incentive Stock Options (ISOs)

ISOs are a little more complex than NSOs due to several restrictions on who can receive them, the price at which they are offered and how long the shares must be held after exercise. If you follow all of the rules for ISOs, you may achieve tax benefits that aren't available with NSOs.

In order to qualify as an ISO, the option must be granted to and exercised by current employees only. In addition, the option must have a grant price that is not less than the stock price on the grant date and must have an option term of 10 years or less. When you exercise ISOs, you must hold the shares for at least two years after grant and for at least one year after exercise. If all of these requirements are met, the spread and any subsequent appreciation will be taxable as a long-term capital gain when you sell the shares. If all of the requirements aren't met, the options will receive the same tax treatment as NSOs.

Like NSOs, there is no taxable event when ISOs are granted. When you exercise the ISO, the exercise price becomes your cost basis for the shares you've purchased. The spread is taxable when you sell the shares.

Although exercising ISOs does not result in a taxable event for regular tax purposes, the spread is considered a preference item for Alternative Minimum Tax (AMT) purposes. As a result, exercising ISOs and holding the shares can result in an AMT liability. Consult your tax advisor for guidance on your particular tax and AMT situation.

The Alternative Minimum Tax (AMT)

AMT is a separate income tax calculation that must be made in addition to your regular income tax calculation. The purpose of the AMT is to ensure that all individuals pay at least some amount of tax. It was created many years ago in response to a number of high-income taxpayers who were able to greatly reduce or completely eliminate their tax liability by taking advantage of large deductions. The AMT calculation disallows or limits certain deductions that are available under the regular tax system and taxes certain income that is not taxable under the regular tax system. One such item is the spread on incentive stock option exercises.

The AMT for individuals is calculated on IRS Form 6251. If you have an AMT liability in any year, a portion of it might be available to be used as a credit against your regular tax liability in future years (reported on Form 8801).

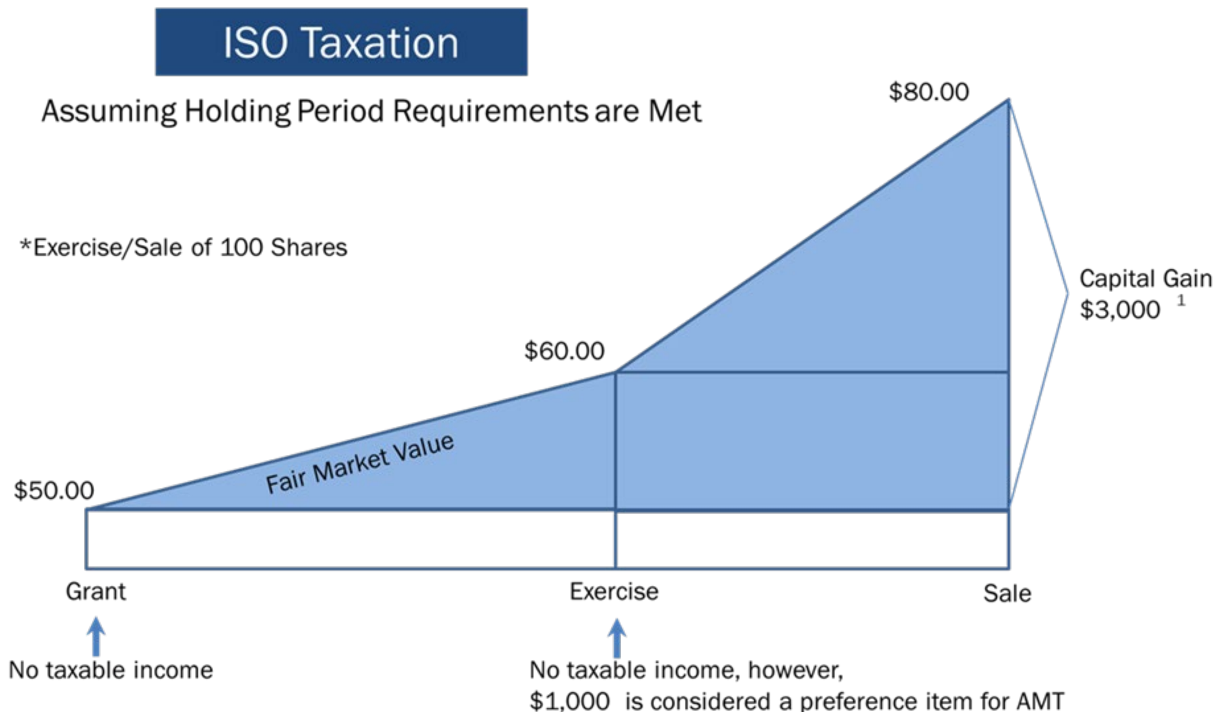
When planning for ISO exercises, you might want to avoid the AMT by keeping your exercises under a certain threshold each year. Consult your tax advisor regarding planning for the exercise of ISOs and any resulting AMT implications.

ISO Example - Assume that on January 1, 2010, you are granted ISOs to purchase 100 shares of ABC stock at $50 a share. You exercise the options on July 1, 2011, when the price of ABC stock is $60 a share. You then hold the shares you've purchased until August 1, 2012, when you sell them for $80 a share.

When you exercise, you do not have taxable income for regular tax purposes. However, you do have AMT income of $1,000 ($10 spread per share, times 100 shares). Your regular tax cost basis for the shares is now $5,000 ($50 a share times 100 shares), and your AMT cost basis is $6,000 ($50 a share plus $10 a share spread, times 100 shares).

Because you have met the holding period requirement by selling later than one year after exercise and two years after grant, you get to enjoy long-term capital gains treatment on the entire gain, including the spread at exercise. Therefore, your 2012 long-term capital gain on the sale of the shares is $3,000 ($8,000 sale proceeds minus $5,000 cost basis).

For AMT purposes, your 2012 long-term capital gain is only $2,000 ($8,000 sale proceeds minus $6,000 AMT cost basis). Because your 2012 AMT capital gain is less than your regular tax capital gain, you may be eligible to take a tax credit for the AMT tax you paid on the spread in 2011 when you exercised the ISOs. You should consult your tax advisor for assistance in reporting the ISO exercise and subsequent sale accurately so that you don't miss out on potential tax savings that would result from a tax credit.



[1] Assumes the sale occurs more than two years after the options were granted and more than one year after the options were exercised, the holding period has been met and the transaction qualifies for long-term capital gains treatment.

If you sell shares acquired through an ISO exercise prior to meeting the holding period requirements for ISOs, you have made a "disqualifying disposition." Keep in mind that a disqualifying disposition results in the shares being treated as if they were acquired through the exercise of NSOs. It's important to note that a disqualifying disposition after the end of the year in which the ISOs were exercised will not eliminate the AMT issue for the year in which the shares were purchased; the disqualifying disposition must be made prior to the end of the same tax year in which the shares were purchased in order to eliminate the AMT treatment on the spread. Again, please consult your tax advisor to avoid any unintended tax consequences when exercising ISOs.

Another consideration for those with ISOs is that you must continue your employment in order to receive ISO treatment on exercise. Make sure you understand the consequences of a separation from service, including separation due to termination, voluntary separation, retirement, disability or death. The consequences for each of these different scenarios could be very different. Planning ahead (whenever possible) may save you a considerable amount in income taxes.

Vesting

Most stock option plans require a waiting period after the grant date before you can exercise your options. The reason for this is to encourage you to continue your employment with the company and work to make the company more profitable, thereby increasing the stock price (and the value of your options). This waiting period is called the "Vesting Schedule."

Vesting Schedules can vary greatly. Some of the more common Vesting Schedules are as follows:

Straight Vesting - Straight vesting is the most common way to vest. Under this method, you become eligible to exercise a certain percentage of your options each year. For example, you would vest in 20% each year for five years beginning one year after the grant date.

Step Vesting - Step vesting is similar to straight vesting, except the percentages in which you vest each year vary. For example, you might vest in 20% after one year, 30% after two years, and 50% after three years.

Cliff Vesting - Cliff vesting results in all options vesting on the same date, usually 1-5 years after the grant date. An example of cliff vesting is if you vest in 100% of the options three years after the grant date.

Performance Vesting - Performance vesting is a newer and less common form of vesting that ties the right to exercise with meeting certain performance goals, such as revenue or stock price targets. Performance vesting is seen more in small businesses than in large corporations. Some examples of performance vesting are that you vest in 100% of the options at the end of the first year if company revenue is increased by at least 10% over the prior year; or you vest in 50% of the options at the end of the first year if revenue is increased by at least 6% over the prior year.

When to Exercise Options

Once you vest in your stock options, the obvious question is, "When should I exercise my stock options?" The answer to that question varies depending on the circumstances and your goals.
If the current stock price is higher than the exercise price, then the options are "in the money" and appropriate to exercise. However, if the current stock price is lower than the exercise price, then the

options are "out of the money" (or "under water") and it doesn't make sense to exercise them because you could purchase the shares on the market at a lower price than you'd pay by exercising the options.

If you plan to hold the shares after exercising in order to get long-term capital gains treatment on the growth, it may make sense to exercise sooner rather than later. Assuming the stock price is rising, you will pay tax on a smaller spread (in the case of NSOs) or less AMT on the spread (in the case of ISOs).

If you plan to exercise and sell, it might be worth it to wait longer to increase the value of the options on a tax-deferred basis (because there aren't any tax consequences until you exercise). However, be mindful of the expiration date—particularly if you are working with multiple grants—to avoid waiting until the last minute and possibly being forced to exercise, therefore having no control over the timing of the exercise and the resulting tax consequences. Of course, you also want to keep an eye on the expiration dates to avoid having any options expire without exercising them, because if they are in the money, you are essentially leaving money on the table.

Funding Methods for Exercising Options

Once you decide to exercise, the next logical question is, "How will I pay for the exercise of my stock options?" There are several methods available for funding the exercise of your options.

Cash Purchase and Hold - If you have the cash available to pay the purchase price, you can simply purchase the shares yourself. However, raising sufficient cash to pay the purchase price can be difficult. You may owe taxes as a result of your exercise, and this amount may need to be tendered at purchase as well. In addition, purchasing and holding more shares may increase an already large position that you have in your employer stock, thereby creating more risk in your portfolio than you intended. Be sure to discuss your asset allocation with your financial advisor to minimize over-exposure to any one holding.

Cashless Exercise - A cashless exercise is the most common method of funding stock option exercises—particularly NSO exercises. Under this method, you do not need to come up with the cash to exercise. Instead, the stock is bought and sold at the same time, and you pocket the difference between the proceeds from the sale (net of broker's fees) and the exercise price. The firm who handles the options transaction lends you money to buy the shares and then sells the shares immediately. The firm then disburses the net cash to you after the sale of the shares has settled (or helps you to invest the cash into a diversified portfolio). Your financial advisor can assist you with a cashless exercise of your stock options.

Sell to Cover - When you sell to cover, you combine a cashless exercise with a cash purchase and hold exercise. You use the cashless method but then sell just enough shares to cover the cost of the exercise. Any excess shares that aren't sold to cover the costs are then held for investment. The advantage is that you don't have to come up with cash to exercise, but you still get to maintain an investment in some of the shares for sale at a later date. Note that this method is only available if the stock price has appreciated enough to cover your

out-of-pocket expenses. Your financial advisor can assist you with a sell-to-cover exercise of your stock options.

Stock Swap - Some companies allow stock swaps as another method to exercise. In a stock swap, you trade shares of company stock that you already own to pay the exercise price on the new shares. The stock price of the shares you own will determine how many options you can exercise. One nice feature of a stock swap is that you avoid capital gains taxes on the shares you surrender because your cost basis in the old shares becomes your cost basis in the new shares. However, your holding period for the new shares starts as of the day of the swap. Note that stock swaps can create tax accounting complexities. If you decide to implement this method of funding your exercises, consult your tax advisor.

As you can see, there is much to consider when you receive stock options from your employer. It's important to work closely with your financial advisor and your tax advisor to ensure that you are maximizing the value of your stock options and minimizing your costs associated with them. Doing so can help you to accumulate wealth from your options and build a diversified portfolio that will help you to meet your financial goals. ■

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