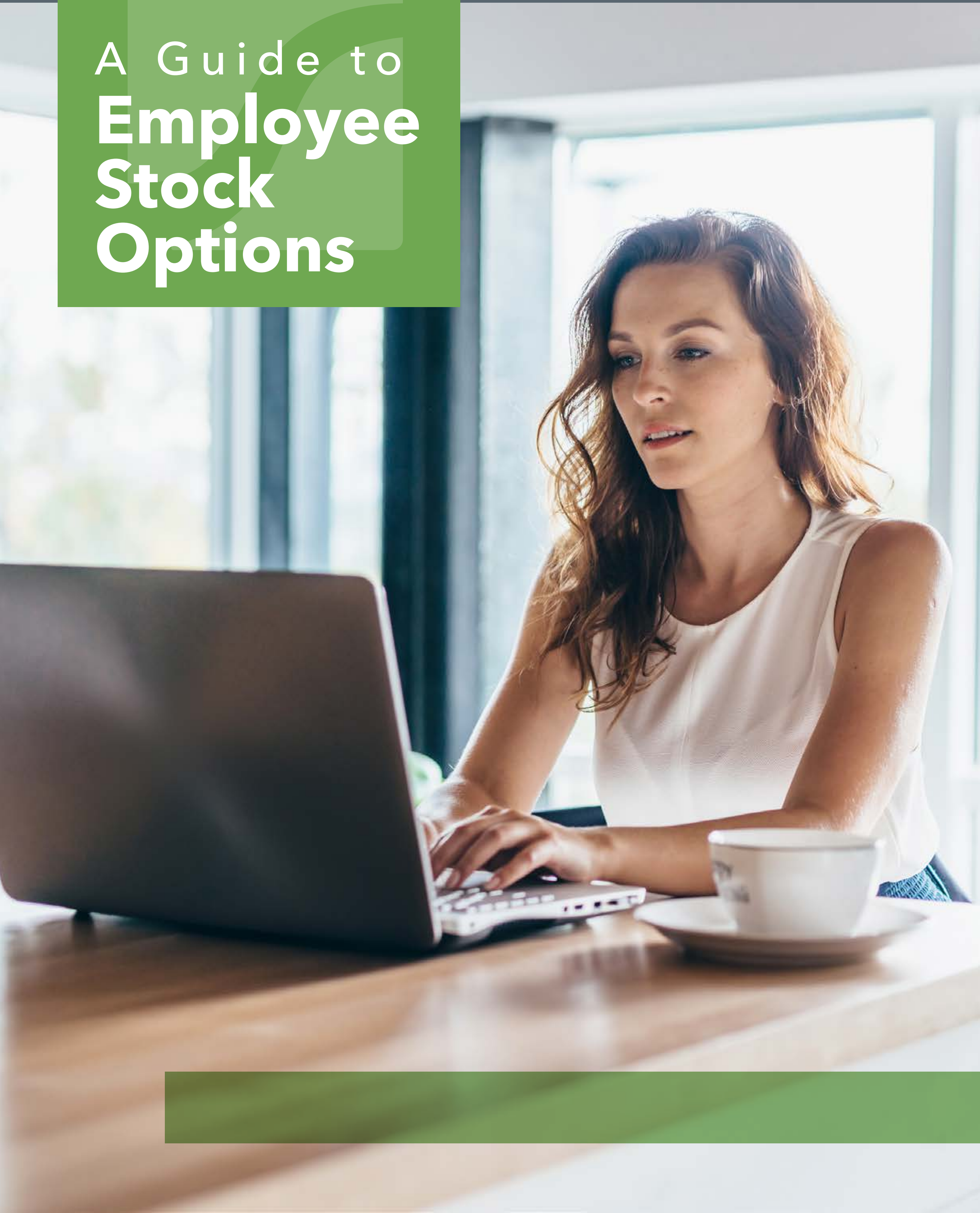
A Guide to Employee Stock Options



A Guide to Employee Stock Options

In 1987, a 28 year-old unhappy assistant at Microsoft perpetually had one foot out the door. Ten years later, he retired from that job a millionaire at the age of 38. How? Stock options. At the time, Bill Gates was offering all full-time employees options as part of their compensation. (You can read more about Randall Thatcher in the Washington Post).

Stories like these tend to be the ones that make their way into the news cycle, and certainly make stock options seem like a no-brainer when it comes to considering a compensation offer. But there's more to stock options than 30-something millionaires and easy money. In fact, many people know very little about employee stock options.

Wondering why your employer may include stock options in compensation offers? There could be a few reasons. The first is to encourage employees to stay with the company. You can't do anything with your stock options until a certain amount of time has passed, and you may lose your options if you leave the company early. Offering stock options also incentivizes employees to work with the company's long-term growth in mind; this is especially useful at the executive level. On the other hand, cash-strapped companies may also offer stock options to compensate for paying moderate salaries.

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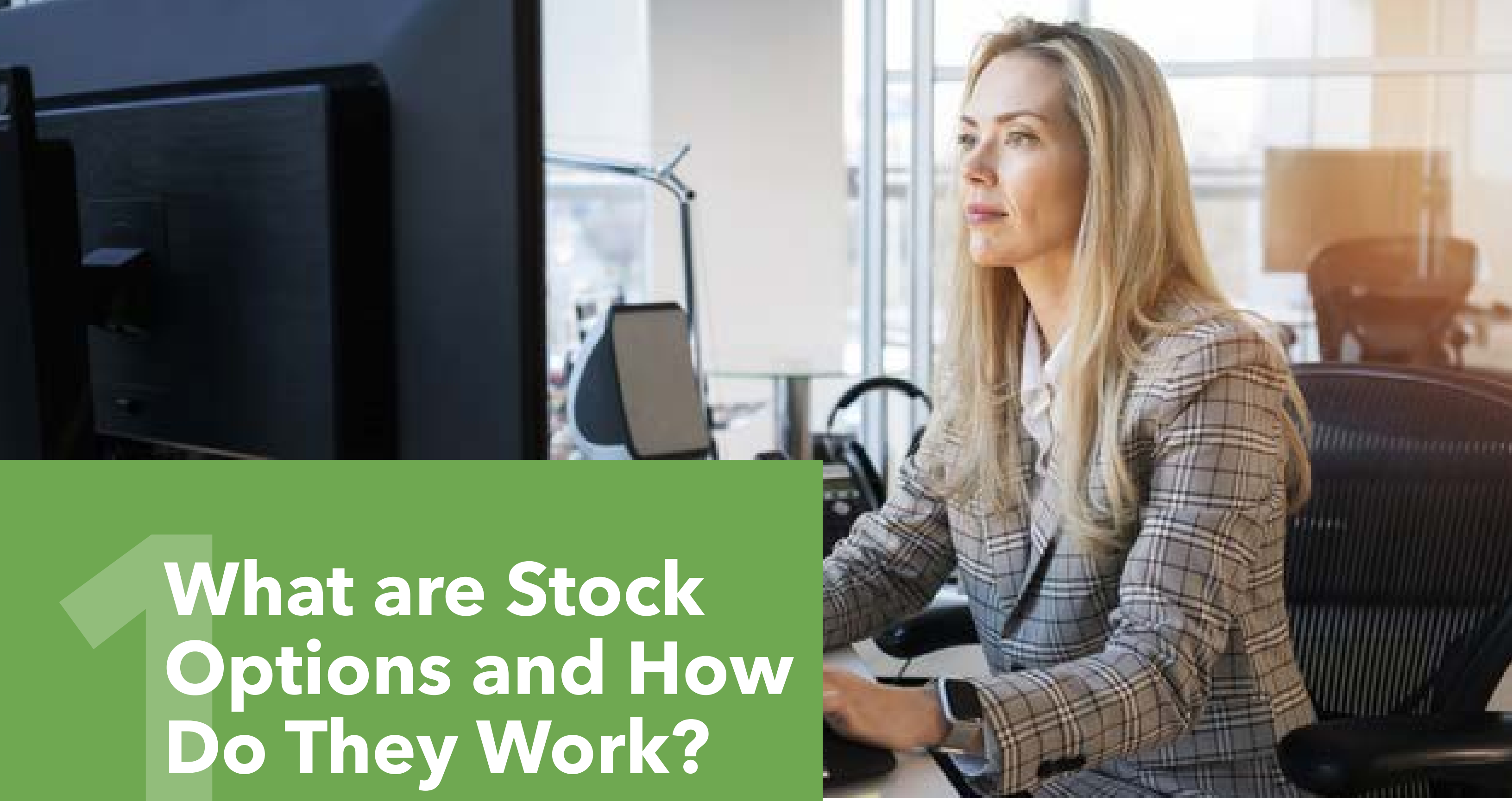
Considering the variety of investment types available to the average American worker, it's no wonder that many people aren't that familiar with the ins and outs of employee stock options (ESO). That's probably because they're not relevant to everyone, since employee stock options aren't something you can buy on the open market. Companies often grant ESOs to compensate, incentivize and retain their employees, as well as their consultants, directors and other service providers. When you're granted ESOs, you're being given the opportunity to buy shares of company stock at a price that may be well below current market value. The higher the company's stock price goes, the more profit you stand to make when you eventually sell your shares.

Being granted employee stock options is a potentially lucrative opportunity. But like with all investment vehicles, there are some risks and potential drawbacks associated with ESOs. It's important to get the full picture before taking any action. We know there's a lot of confusion out there about how employee stock options work, and how to capitalize on them to grow your wealth. Use this guide as your introduction to ESOs—and then reach out for help implementing your plan.

A note on the lingo: There are many technical terms when it comes to understanding stock options. We've included a glossary in the middle of this guide, so you can turn there for further clarification.



1 What are Stock Options and How Do They Work?

The first time you're offered stock options, you may have no idea what to do with them—or even how stock options work. Companies often offer stock options as part of an employee's compensation package. They can be highly rewarding, but only if the company's stock is doing well when it's time to exercise your options. Not sure what that means? Don't worry, we get to that below. Additionally, the tax implications can be complicated. If you're just starting out with stock options, here's what you need to know.

What Stock Options Are

When an employer offers an employee stock options, they're essentially giving the employee the chance to buy a number of shares in the company's stock for a predetermined price, theoretically below market value. Generally, the employee has to wait a number of years before being able to purchase the shares, known as 'exercising' that power. When that waiting period ends, the employee may be able to make a significant profit…if the company's stock is worth more than the predetermined price the employee pays. The value of stock options is tied to the performance of the stock. So, if you have options for company stock and the company does well, you'll share in its success. If the stock doesn't do well, you won't make money.

How Stock Options Work

When you receive stock options from your employer, all the terms will be laid out in a contract stating the number of shares you'll be able to buy, and the exercise or strike price of the shares (what you'll pay when they vest). The contract will include a vesting schedule, dictating how and when you can exercise control of your options. This varies from company to company. Often your stock options vest gradually, so you can exercise a percentage of the options each year.

You don't have to exercise your right to buy shares when your options vest, but you do have a limited window to do this. Stock options have expiration dates. Typically, you'll have no more than 10 years from the grant date to "use or lose" your stock options. If you decide to leave the company after your options vest, you may have a short window to exercise your options before losing them.

As an example of how stock options work, let's say that your employer offers you the option to buy 5,000 shares at an exercise price of $10 per share with a five-year vesting period. When your stock options fully vest after five years, the market price of the shares is now $25. Your stock options locked you into that $10 price, so you can buy 5,000 shares for $50,000. Now you can turn around and sell your shares for $125,000 (5,000 x $25). Or, if you think the stock price will continue to rise, you can hold onto your shares.

Sometimes, the market value of the company's stock is lower than the exercise price. Using the above example, let's say your options fully vest after five years and the market value is $5 a share. Unfortunately, your stock options are worthless. You only make money when the company does well. (This is one of the primary disadvantages of employee stock options. If the company's stock price drops because the company isn't doing well, you can't make any money with your options and your job and income might be in danger. It's risky to put too much weight on stock options as part of your portfolio.)

How Stock Options are Taxed

Be prepared for the tax implications of stock options before making any decisions about exercising them. How you'll be taxed depends on a variety of factors, so it's a good idea to talk with your tax advisor before taking any actions. There are two types of stock options: non-qualified stock options (NSOs) and incentive stock options (ISOs). They're taxed differently, so it matters which kind you've been granted. If you exercise non-qualified stock options, and pay less for the shares than they're currently worth, the difference between those prices will be taxed like normal income. In the above example, when you pay $50,000 for shares that have a market value of $125,000, the difference of $75,000 is taxed as ordinary income—but only with non-qualified stock options. ISOs don't have this tax obligation.

With either kind of stock options, you may owe capital gains taxes if you sell your shares. How long you hold the shares will come into play when determining your capital gain tax obligations, so it's critical to talk strategy with your financial advisor before exercising any stock options.

Understanding how stock options work is just the first step in taking advantage of the opportunity you've been given. Then you will want to work with your financial advisor to see how your stock options fit in with your financial planning, including tax planning. Be sure to consider diversification, cash flow and tax implications. With an appropriate strategy in place, stock options can be a lucrative element of your portfolio.

2 What You Need to Know About Stock Options and Taxes

Stock options can be a highly profitable part of your portfolio. As long as you stay with your employer and the company performs well, you may be able to secure a significant profit within a few years of being granted stock options. The tax implications of stock options can be daunting, but that shouldn't scare you away from exercising the options you've been given. Here's an overview of what you need to know about stock options and taxes.

1. Your tax obligation doesn't begin until you exercise your stock options.

When your employer grants you stock options, you're only being given a promise: That you'll be able to buy company stock, for a predetermined price at a predetermined point in the future. Assuming the company does well and the stock's market price is higher than your grant price when you eventually sell your stock, you may be able to make a quick profit. Or, if the company isn't doing well when your stock vests (the date they're available to exercise or buy), your stock options may be worthless.

Because you're not able to do anything with your stock options until they vest, you're not generating any income for the IRS to tax. Don't worry too much about your tax obligations when your company first offers you stock options, but do discuss it with your CPA as part of your tax planning.

2. Different types of stock options are taxed differently.

Stock options generally fall into one of two categories: Non-qualified stock options (NSOs) and incentive stock options (ISOs). Employees may receive either NSOs or ISOs from their employers. The major difference between these two types of stock options is the way they're taxed, so it's important to know what kind of stock options you have; refer to your grant agreement if you're not sure.

For a demonstration of how NSOs and ISOs are taxed differently, let's say you decide to exercise 1000 shares of stock with a grant price of $10 and a market price of $30. You're able to buy those shares for $10,000, though they're worth $30,000 if you decide to sell.

With non-qualified stock options, the IRS considers the $20,000 difference between the grant price and the market price to be compensation. Your employer will report this as income and you'll pay ordinary income tax on that $20,000—even if you haven't sold your stock yet. When you do sell, you'll have to pay taxes again on any gains.

With incentive stock options, you may get a tax break. You only have to pay taxes when you sell the stock. Exercising your options doesn't automatically trigger tax the way it does with NSOs. You still have to pay taxes when you sell the stock, but holding onto it for at least a year may let you avoid paying the income tax rate in favor of the lower capital gains tax rate—more on that next.

However, you do have to consider any exercised ISOs when calculating any alternative minimum tax you may owe; this is something to discuss with your tax advisor.

3. Exercising stock options may trigger the capital gains tax.

Sometimes, holding stocks long-term can yield a greater return than buying and selling quickly. The capital gains tax kicks in when you keep stocks for a holding period of at least one year after exercising your options, and at least two years after being granted the options. Both ISOs and NSOs are subject to capital gains taxes. (Or, if you have to sell stock at a loss, you may be able to claim a capital loss.)

Because high-income investors will have a lower capital gains tax rate than income tax rate, waiting to sell stock until the holding period is over could significantly lower your tax bill. Of course, fluctuating market prices mean that there's some risk with holding onto stock long-term, so you'll want to carefully consider your options before selling.

4. A lot of variables affect how much tax you'll owe.

Tax rules around stock options are notoriously complicated. On your own, it can be difficult to predict how much tax you'll have to pay when exercising and/or selling stocks. Your specific situation will affect how much you'll owe. For example, what's your filing status? Are you going to have to pay any alternative minimum tax? What else is going on with your overall tax strategy for the year?

Reporting stock option compensation correctly can also be difficult. There may be some complex calculations required, and you may need to file multiple forms to properly report all the moves you've made around stock options during the year. Most people won't want to attempt doing this alone, as it's easy to make mistakes.

Despite the potentially daunting tax implications, being granted stock options can be a very profitable opportunity. Advance tax planning lets you maximize your earnings, minimize your tax obligations and make filing as easy as possible.

A Guide to Stock Option Terms

One of the reasons that employee stock options can seem intimidating at first is that you may not have the vocabulary to talk about them. It becomes much easier to understand your choices and responsibilities around stock options once you speak the language—or at least know what questions you need to ask your financial planner. These are the stock options terms you need to know.

- **Employee stock options:** Employee stock options are essentially contracts through which a company gives an employee the right to buy a set number of shares of company stock, for a predetermined price, at a predetermined point in the future. If the company's stock price rises, the employee can sell their shares for more than their purchase price and make a profit.
- **ISOs (incentive stock options):** ISOs are one of the two kinds of employee stock options. The two types work similarly but are taxed differently. ISOs generally have the more favorable tax treatment, and are granted only to employees.
- **NSOs (non-qualified stock options):** Sometimes abbreviated as NQs or NQSOs, these are the second type of employee stock option. They generally have a less favorable tax treatment than ISOs, and companies can give them to people other than employees. A company may grant NSOs to its employees and/or to consultants, directors, independent contractors and other non-employee service providers.
- **Granting:** In stock options terms, granting essentially means offering. When your company grants you stock options, you're being offered the chance to buy shares of stock. It's your choice whether or not you act on the offer.
- **Exercising:** When you exercise your options, you're buying the shares that your employer granted you.
- **Grant date/issue date:** The grant date or issue date is the date on which you're officially given your stock options. This is when the clock starts on your vesting schedule.
- **Grant price/exercise price/strike price:** This is the price you'll pay per share if you decide to buy the stock when your options vest. If you're granted 1,000 shares with a grant price of $5, as of your vest date you can buy those shares for $5,000—no matter what their current market value is. (Though it is not required that you buy all available shares.)

- **Vesting:** When stock options vest, they're available to you to buy. Stock options don't have any real, monetary value to you until they vest.

- **Vesting schedule:** The vesting schedule spells out how long it will take your options to vest. Often, employee stock options vest gradually over the course of several years; for example, your vesting schedule might allow you to exercise 25 percent of your shares starting one year after your grant date, 50 percent after year two and 75 percent after year three. You would be fully vested after year four, at which point you can exercise all of your shares.

- **Holding period:** If you have ISOs, the holding period determines whether any gains you earn from selling your shares are taxed as regular income or as capital gains. Typically, employee stock options have a holding period of one year from the grant date. If you sell during the holding period, any gains are taxed as income. If you wait one year and one day, until the holding period is over, any gains from the sale will be taxed at the (usually lower) capital gains tax rate.

- **Spread:** The spread is the difference between the grant price of your shares and the market value of those shares, at the time of exercise. Say that when you buy 1,000 shares for $5,000, the current market value for 1,000 shares is $20,000. The spread is $15,000. With non-qualified stock options, the spread is taxed as ordinary income when you exercise the options.

- **Cashless exercise/cash exercise:** Let's say you decide to buy your shares when your options vest. With a cash exercise, you use your own money to pay the grant price; essentially, you're writing a check to buy the shares outright. If you can't access enough money to cover the cost, or don't want to use your own money, you may be able to use a cashless exercise to buy shares. There are a few ways to do this; for example, a brokerage firm may put up the money to buy the shares, then immediately resell them and give you your portion of the proceeds (minus taxes and the firm's fee).

- **Cliff:** When options vest gradually, the vesting schedule may include a cliff. This is the point at which your first portion of shares vest. Employee stock options often have a one-year cliff; if you leave the company before reaching this point, you forfeit your shares.

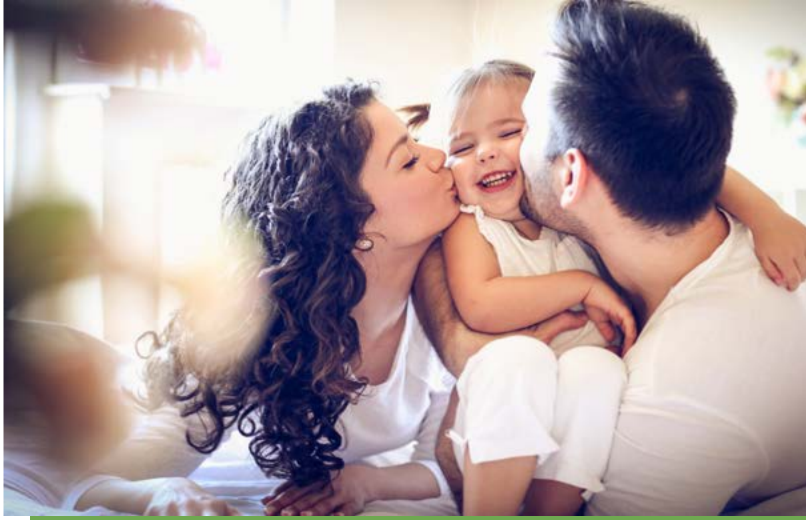
- **Expiration date:** Employee stock options expire after a certain amount of time. The expiration date is often set as 10 years from the grant date. Once you reach the expiration date, any options that you hadn't yet exercised are worthless.

4

How to Think About Stock Options as Part of Your Financial Future

Many people don't know quite how stock options fit in with their larger financial goals. On one hand, you might prefer to have a bigger paycheck today than be given an offer that may or may not end up being worth anything years down the line. On the other hand, employee stock options can end up being an extremely lucrative part of your financial plan. And because you don't have to do anything with stock options you've been granted, there's no financial risk to you unless you choose to exercise those options.

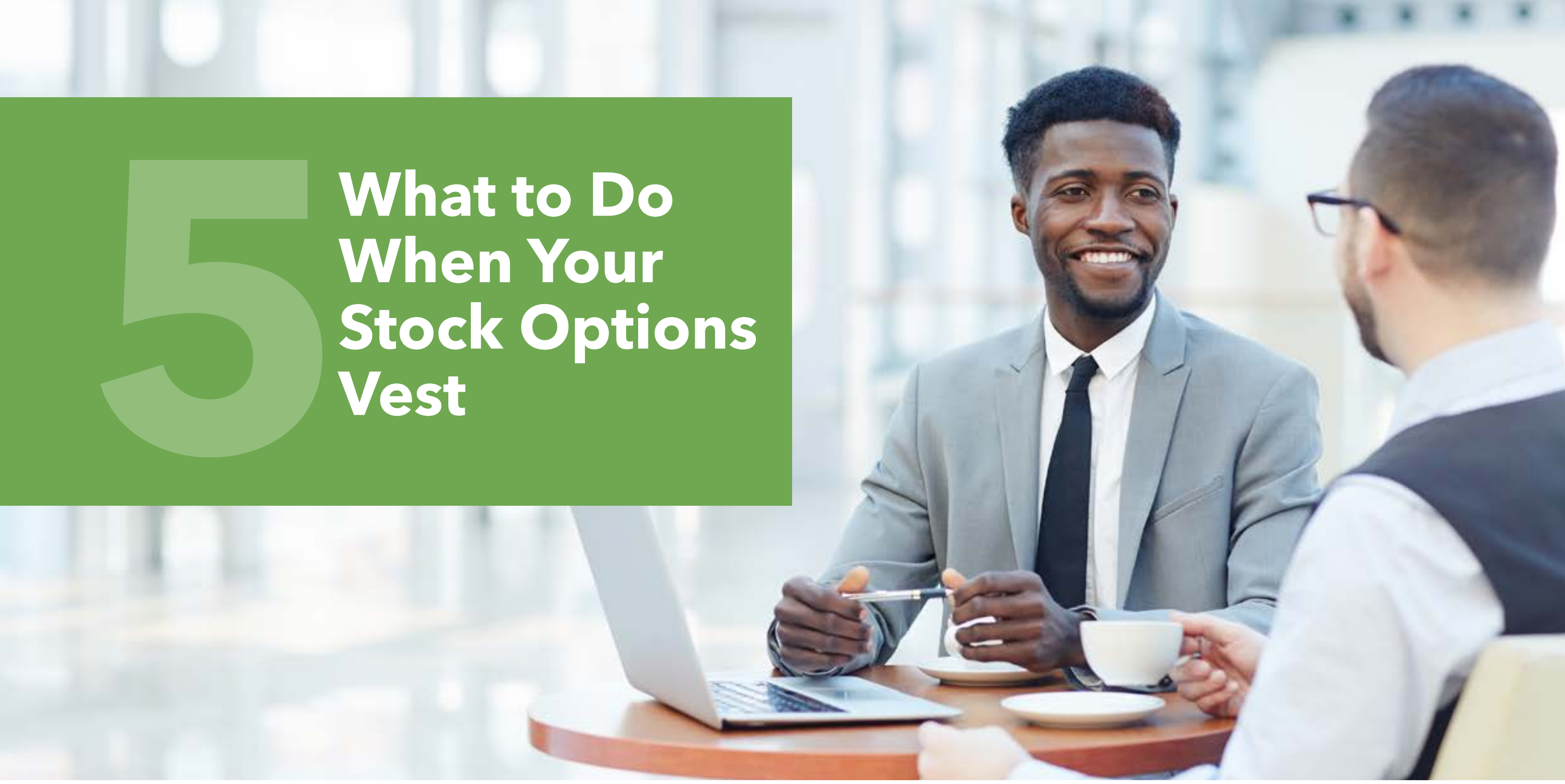
A Guide to Stock Option Terms (cont.)



Your unique situation will determine the role that your stock options play in your overall financial plan. These are some of the things you might want to consider as you think about stock options as part of your financial future.

- You can't count on any guaranteed outcome. You may want to keep in mind the old saying about not counting your chickens before they hatch. Employee stock options may ultimately net you a big payout, but it's imprudent to put too much stock (pun intended) in your options until they vest and you're able to sell them. Any number of market forces can affect a company's stock price. Stock options don't represent guaranteed income the way mutual funds and other investment vehicles may, so they generally shouldn't make up the core of your financial plan.
- Be thoughtful about diversification. Owning too much of one company's stock puts you in a vulnerable position, especially if that company is your employer. If the stock price drops because the company is struggling, employees could lose their jobs and the value of their stock options around the same time. If you want to exercise and hold shares, make sure you're working with a financial planner to ensure that your portfolio is well balanced and you're not exposed to too much risk. Alternatively, you could sell quickly after exercising your shares, but you will want to be mindful of the tax implications.
- You have to prepare for the tax bill before making any moves. How and when you'll be taxed depends on whether you've been granted ISOs or NSOs, and on how long you keep any shares before selling them. But if your options are lucrative, you could end up with a much bigger tax bill than you anticipated. Make sure you know what your tax obligations are going to be so you can more accurately estimate your net proceeds from any sale.
- Do the math before making a cash exercise. Will purchasing shares require you to take out a loan or pull money from another investment? Consider whether this is ultimately the best move for your overall financial plan.
- Stock options won't always be worth taking a job for, or be worth sticking around long term. Granting stock options may allow a cash-strapped company to attract top employees while paying lower salaries than their competitors. Companies also use stock options to encourage retention, by requiring employees to forfeit their stock options if they leave the company before the options vest. Sometimes, taking a more lucrative job somewhere else is the better financial move in the long run, even if it means sacrificing stock options. Make sure to consider all your opportunities when making any career decisions that affect your stock options.

Ultimately, remember that stock options are just that: options. They may prove to be a highly profitable part of your portfolio, but they're just one small part of your financial picture. To make the decisions that best support your goals, work closely with a financial planner before exercising stock options.



5 What to Do When Your Stock Options Vest

Stock options may be a pretty low-maintenance part of your financial plan for the first several years after they're granted. You might sign a few papers every now and then, but there aren't any major decisions to be made until you can actually buy the shares. When your options vest, you can start making moves—but only once you've done your homework.

1. Review Your Options Agreement

If it's been a few years since you last reviewed the details of your stock options grant agreement, it's a good idea to do that now. It's important to know whether you have ISOs or NSOs, and to know your expiration date—the date by which you must exercise your options, if you're going to do so. Your grant agreement will also list the number of shares covered by the option and your exercise price. Review the entire agreement so it's all fresh in your mind before you make any decisions.

2. Review the Stock Options Tax Rules

Hopefully, the company's stock price is high when your options vest. Buying and then turning around and selling the shares quickly could generate a useful influx of cash—but it will also trigger tax payments that you may not be prepared to pay. Whether you have ISOs or NSOs will determine when you're taxed on any exercise. With both types of employee stock options, you'll pay tax on any gains. It's important to understand the basic tax obligations of the options you've been granted; they'll affect how much you're actually able to net from any sale.

3. Evaluate Your Ability to Exercise

Let's say the company's stock price is at an all-time high, and you're eager to exercise your options. Even if you anticipate quickly selling the shares for a profit, it's important to consider whether you're able to pull together enough cash to buy them without disrupting your other investments. (If you have NSOs, you may also need to plan on paying tax at the time of the exercise.)

Even if you don't have enough cash on hand, in some cases you'll still be able to exercise your stock options. There are a few ways to handle a cashless exercise, which is exactly what it sounds like: a way to buy shares without paying upfront for them. Often this is done with the help of a brokerage firm, which essentially fronts the money to buy the shares, then sells them the same day and sends you the proceeds minus taxes and fees.

4. Consider the Company's Future

When you exercise employee stock options, you're buying a small piece of your employer—so the company's current performance and trajectory are certainly things to consider. Do you want to buy that stock and hold onto it because you believe the company will continue to flourish? Or do you have concerns about the company's direction and want to cut all ties now? Like all elements of your financial plan, your stock ownership should align with your personal and financial priorities.

5. Consult Your Financial and Tax Planner

Even if you're confident about what you want to do when your stock options vest, it's inadvisable to make any decisions before talking with your financial and/or tax planner. And if you have no idea what to do when your stock options vest—all the better.

Your financial advisors can help you determine the best way to maximize your opportunity. You may have multiple strategies available when your stock options vest, each with its own pros and cons. Working with real numbers and considering multiple projections will help you understand how your stock options translate to real dollars.

6 Incentive Stock Options (ISOs) vs. Non-Qualified Stock Options (NSO)

The differences between incentive stock options and non-qualified stock options is one of the topics that trips up a lot of people who are new to employee stock options. ISOs and NSOs function very similarly, but there are a few key differences between them–primarily in how they're taxed.

What are Incentive Stock Options?

Incentive stock options are a type of stock option that a company can grant only to its employees. ISOs are sometimes considered preferable to NSOs because of their tax treatment. Depending on what you do with ISOs, you may keep more money than you would with NSOs.

Here's a basic overview of the tax treatment of ISOs. You're not taxed when you're first granted stock options. When your options vest, you may decide to exercise them and buy the shares you've been granted. With ISOs, exercising an option doesn't trigger any tax—but you do still have to pay tax on any money you earn when you eventually sell your shares.

Timing is very important here. If you sell shares within the same year that you exercised your options, you have to report your profit to the IRS as ordinary taxable income. If you hold onto your shares for at least a year and a day, when you do sell them any gain is taxed as a capital gain. Because many individuals have a higher income tax rate than capital gains tax tax rate, holding onto shares can be advantageous.

Let's say your employer grants you ISOs. Upon vesting, you can buy 1,000 shares for a grant price of $10. You're not taxed on this $10,000 purchase. If you immediately turn around and sell your shares for the current market value of $30,000, the IRS considers your $20,000 gain to be ordinary taxable income. You may pay 35 or 37 percent tax on that profit. If you hold onto those shares and sell them 14 months later for $35,000, you might pay a capital gains tax of 15 or 20 percent on a $25,000 gain.

What are Non-Qualified Stock Options?

Non-qualified stock options can be granted to a company's employees as well as other service providers such as independent contractors and consultants.

With NSOs, you're taxed twice: First when you exercise your options, and then again when you sell. Say you exercise 1,000 shares for $10,000, which have a market value of $30,000. The difference between your grant price and the market value is called the spread—in this case, $20,000. As soon as you exercise NSOs, you trigger a tax on the spread, even though you haven't yet made any money from your shares.

When you do sell your shares, you're taxed on any gain. If you sell them within a year of exercise, you'll pay your ordinary income tax rate on what's considered a short-term gain. If you hold onto the shares for more than a year, that's considered a long-term gain and you'll pay the capital gains tax.

Which Type Do I Have?

Obviously, it's important for tax planning purposes that you know whether you've been granted ISOs or NSOs. (Or both, if you're an employee and eligible for both types of stock options.) Refer to the grant agreement your employer provided when you were granted options. This information, along with any other relevant terms, should be clearly explained within the grant agreement.

What Else Should I Know About ISOs vs. NSOs?

While it's true that ISOs do have more favorable tax treatment in certain circumstances, having ISOs may raise your tax bill if you owe the alternative minimum tax. (The AMT is designed to ensure that high-income filers have to pay a certain amount in taxes each year, no matter how many deductions and/or credits they have.) If you're a candidate to pay the AMT, the spread on your ISO exercise is considered income. When you buy $30,000 worth of shares for $10,000, the $20,000 spread is counted toward your income when calculating how much you owe for the AMT.

Another thing to know about ISOs vs. NSOs is what happens when you leave the employer. ISOs are granted to employees, so your ability to exercise these stock options may be tied to your employment. Commonly, you'll have 90 days to exercise vested stock options after leaving the company. Because NSOs can be granted to non-employees, they generally don't have the same requirements. Your specific grant agreement will clarify any terms around exercise requirements.

These are the basic ways that ISOs and NSOs differ, but there are also some other, subtle differences between them. This is one more reason why it's advisable to talk to your financial and tax planner before exercising stock options.

Conclusion

Still have questions about employee stock options? We're sure you do! They're not simple, but ESOs can be well worth any effort. The most important thing to understand about navigating the world of employee stock options is that you shouldn't attempt to do it alone. It can be difficult to anticipate all the potential consequences of an exercise without the help of a financial planner who has experience in this area.

Sachetta Callahan is here to help you understand your options and make the financial moves that move you closer to your goals. We welcome all your questions about employee stock options!

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