

## **FIVE THINGS TO KNOW ABOUT YOUR STOCK OPTIONS**

Today's regulatory environment is tougher than ever and employee stock option plans are becoming increasingly controversial. New laws, cases and rulings have fostered creative and complex compensation arrangements. It is critical to understand how these options add to your net worth.

### **Understand what the option is.**

A stock option is issued to employees of public companies as a form of equity compensation. The stock option gives the employee the right to purchase shares of stock at some time in the future under specific terms. Options are exercised when the holder of the option uses it to buy shares of stock. To exercise the option, the optionee must pay a price specified in the option agreement. This price to be paid goes by various names: exercise price, strike price, grant price or the option price.

Example: Mary was given an option to purchase 1,000 shares of her company's stock at \$25/share. If Mary exercises all the option shares, she will pay \$25,000 (\$1,000/shares @ \$25/share) and will own shares worth \$40,000.

### **Understand the vesting schedule.**

Generally, the recipient of a stock option is not allowed to exercise immediately. As it relates to stock options, the term vested is often used as a synonym for exercisable. In other words, an option is considered vested when enough time has passed so that the option holder is allowed to exercise it.

Example: John received an option 18 months ago. Under the terms of the option agreement, he can exercise 25% of the option after the first anniversary of the date it was granted (issued), 50% after the second anniversary, 75% after the third anniversary, and 100% after the fourth anniversary. The option is currently 25% *vested*.

### **Understand the value of the option.**

The two components that make up the value of an option are the intrinsic value (profit) and the time value.

In the previous example with Mary, her intrinsic value was \$15,000 (\$40/share - \$25/share @ 1,000/shares). Time value is a theoretical value that is built into the option based upon the potential profit from continuing to hold the option.

### **Understand the type of stock option.**

There are two types of stock options that companies may issue: incentive stock options (ISO) and nonqualified options (NQO).

### Tax Considerations:

**NQO's** – The employee does not report income at the time she receives the stock option or when it becomes exercisable. When she exercises the option, she reports compensation income (ordinary income) equal to the difference between the value of the stock and the amount paid to buy it under the stock option (bargain element).

Example: Jill exercises a NQO, paying \$20,000 for stock currently worth \$55,000. Assuming the shares are vested when received, she must report compensation income at that time in the amount of \$35,000.

**ISO's** – The tax consequences of exercising an ISO are considerably more complex than for NQO and may involve alternative minimum tax (AMT). There are three different tax outcomes depending upon when the option is exercised and sold.

1. *Shares sold at exercise.*

If shares are sold immediately after exercising the option, the tax treatment is essentially the same as for a NQO.

2. *Shares sold later that year.*

If the shares are held after exercise but sold during the same calendar year, the employee will report compensation income equal to (a) the bargain element at the time of exercise, or (b) the actual profit on the sale, whichever is smaller. AMT generally would not apply unless there is another triggering event.

3. *Shares sold in subsequent year.*

If shares are held through the end of the year, the employee will not report income from exercising the option. They may, however, be subject to AMT for the year of exercise. Many option holders do not realize the impact of paying AMT based on the year of exercise of the ISO, and if the value of the stock declines and is sold in subsequent years, the option holder has paid tax (AMT) on a stock option that could be considerably devalued or even worthless. If the shares are held long enough, they will report a capital gain or loss on the sale.

**5. Understand when to exercise.**

Knowing when to exercise an option is the most difficult question the option holder is faced with. The problem is that when exercising the option you are protecting the intrinsic value (profit) but this will abandon the remaining value of the option or the time value. The profit percentage of an option is the dollar amount of profit the employee can harvest by exercising at the current stock price divided by the value of the stock.

Example: If the stock is currently trading at \$25/share and the employee must pay \$20/share to exercise the option, the profit percentage is 20% (\$5 profit divided by \$25 value). If the employee must pay \$5/share exercise price to acquire stock currently trading at \$50/share, the profit percentage is 90%. An employee with a large percentage of their wealth in company stock should be more motivated to

exercise their options than an employee who has a small percentage of wealth in company stock.

In summary, stock options have allowed employees at companies to share in the success of the companies' growth with no upfront cost. While this created millionaires of some employees, many others were ruined financially during the 2001 and 2002 bear markets. By understanding some of the general characteristics of your options, you'll be on your way to use your options to enhance your wealth.

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