

Knowing Your Options

May 2001

The *National Center for Employee Ownership* estimates that 8-10 million employees currently receive stock options as part of their compensation package. This number has risen 17% from 7 years ago. Additionally, stock option packages are not just being offered to just highly compensated executives. In 2000, for example, the *average* lowest salary for employees eligible to receive stock options was \$58,100. It is not uncommon to see salespersons, engineers and middle management with a considerable amount of personal wealth tied up in stock options. Since both the option programs and the related tax consequences can be complex, we felt it would be beneficial to review key terminology, two common forms of stock options, and some strategies to maximize the value of the options.

Terminology

- **Exercise Price:** the price the employee must pay per share to exercise the option to buy stock.
- **Bargain element:** The amount that the FMV of the stock exceeds the exercise price on the date the options are exercised.
- **Vesting Date(s):** Date(s) when the employee will be eligible to exercise his/her options.
- **Expiration Date:** The final date to exercise the option. Any options not exercised by this date expire worthless.
- **Alternative Minimum Tax (AMT):** a separate, parallel individual tax system that includes the bargain element upon exercise of incentive stock options.

Option Varieties

The two major varieties of stock options are Nonqualified Stock Options (NQSOs) and Incentive Stock Options (ISOs). Presuming that the exercise price is lower than the fair market value at the date of exercise, let's review the tax difference between the two:

- A participant of an ISO is not taxed (for regular tax) on the bargain element, if any, at either at the time the option is granted or at the time it is exercised. If the employee can satisfy certain holding period requirements, any gain on the stock purchase is taxed at long-term capital rates. However, the bargain element at the exercise date may trigger the AMT.
- By contrast, a participant in a NQSO will *immediately* recognize ordinary income at the date of exercise. The income recognized is equal to the bargain element.

Strategies

- The employee should **defer** exercising the stock options if:
 - He/she expects the stock to appreciate considerably;
 - Personal cash flow is limited; and/or to postpone tax liabilities.
- The employee should **exercise and hold** the shares if:
 - The options are about to expire and the shares may continue to appreciate (especially if the bargain element is low);
 - The company may require stock ownership;
 - The employee wants to start the clock ticking on the one year holding period to qualify for favorable tax treatment upon sale.
- The employee should **exercise the options and sell the shares** if:
 - The employee needs the money;
 - The employee wants to diversify his/her investment holdings;
 - The employee doesn't have the cash to exercise and/or the employee thinks the stock price may go down.

A more comprehensive discussion, including certain tax elections, is beyond the scope of this bulletin. If you would like to know more about options, we encourage you to call for a personal analysis. After all, how well you know your "options" may dictate how valuable they become for you.