PCM

Employee Stock Options

THE BASICS

Key Points

- Helpful information for investors who have received stock options from their employers.
- Understanding how to manage your stock options will determine whether you make money or lose money.
- Maximize value and prevent mistakes by understanding how stock options work, vesting schedules, exercise methods, and tax treatment.

We've all heard the stories of people who instantaneously became millionaires on their stock options alone. Then, there is the reality that many find to be a more relatable experience: you have employee stock options, but you don't know what they are or what to do with them.

Yes, employee stock options can be a difficult concept to grasp. The thing to remember is that there is the potential for great reward – down payment for a home, college tuition for your children, early retirement. You might have inertia because of uncertainty on how to proceed.

You should seek professional advice in planning for the exercise and sale of your company stock, and in mapping out tax liabilities. While stock options can be complicated, they're pretty easy to understand once you know the basics of how they work—and you should.

What Is a Stock Option?

A stock option is an agreement between the employer and employee that grants the employee the right, but not the obligation, to buy a specified number of shares of company stock at a set price (known as the strike price), within a certain timeframe. When an employee exercises their stock options they receive shares and thereby obtain the benefits associated with stock ownership.

What is a Stock Option? (cont)

It's important you review your specific plan to know how many and what kind of options you've been granted, and the process to realizing them. Here are some common terms and conditions you should to pay attention to:

Plan type	This establishes the basic frame-work for how the options will work and explains details around the stock offer. Most plans will be taxed based on the plan type.
Qualified or Non-Qualified	The biggest distinctions come down to how they're treated for tax purposes at the exercise date. Normally employees receive Non-Qualified Stock Options (NSOs).
Grant date	The date when you've officially been granted your options. This will help you keep track of important dates like vesting schedules and exercise periods (see below).
Strike (Exercise) price	The amount you'll pay for each share when you exercise your options. Exercising means that you use your options to buy shares of company stock at the strike price. The strike place remains the same even as the price of the stock changes in the open market.
Vesting schedule	In an effort to promote loyalty and retain employees, employers add pre-specified waiting periods, known as vesting periods, before you can exercise your options. Vesting periods can be gradual over several years (i.e. 25% of the issuance per year for four years) or all at once, known as a cliff-schedule (i.e. 100% on the third anniversary of the grant).
Exercise period	This is the amount of time you'll have to exercise your options once they vest (i.e. 10 years from the date of the grant before options expire).
Taxation	One of the major (and most confusing) considerations in maintaining your stock option plan. Taxation rules differ around the various stock option plans.

Please consult a tax professional or a financial advisor for advice on your personal financial situation.

Exercising options

You have the potential to make a profit on your stock options if the market price of your company's stock rises above the strike price.

As noted above, the ability to exercise options is determined by a vesting schedule, which lists the number of shares an employee can purchase on specific dates thereafter. You can exercise your options as soon as they vest or you can wait.

Generally, an employee can choose from three exercise methods. Besure to check your specific stock option plan!

1. Cash exercise

You must provide the money to pay when you exercise your shares. For example, if the strike price is $10 and you exercise 100 options, the exercise will cost $1,000 ($10 x 100) plus transaction fees and any tax withholding.

2. Cashless exercise

If the price of the stock in the open market is higher than your option strike price, you can exercise your options to buy & simultaneously sell the shares of your stock in order to pay the exercise cost, transaction fees & any taxes withheld. You may sell all the shares and pocket any remaining cash, or sell just enough shares to pay for everything and keep the remaining shares in a brokerage account.

In deciding what's right for you consider:

- **The terms of your company's plan documents**
- **The market price of your company's stock**
- **Your financial situation**
- **Taxes**

3. Swap

Some employers let you exercise your options and use company stock that you already own to cover the exercise cost. You may still owe transaction fees and taxes.

Please consult a tax professional or a financial advisor for advice on your personal financial situation.

Stock Option Plans

Some of the most common plan types offered to employees include Incentive Stock Options (ISOs), Non-Qualified StockOptions (NSOs), Restricted Stock Units (RSUs), Employee Stock Ownership Plan (ESOP), and the Employee Stock Purchase Plan (ESPP).

Incentive Stock Options (ISO)

A type of qualified plan that offers the most favorable tax-incentives. A number of shares are offered to the employee for purchase at a specified exercise price. To qualify for special tax treatment, you must hold the shares for a minimum of 2 years from the grant date and 1 year from the exercise date. Once you meet these holding requirements, the ISO avoids ordinary income tax. When you sell your shares, the transaction is taxed at the long-term capital gains rate, 15-20% (your cost basis is equal to the strike price).

Non-Qualified Stock Options (NSO)

A number of shares are offered to the employee for purchase at a specified exercise price. Special tax treatment and holding periods don't apply to NSOs. When you exercise, the difference between the strike price and the current market price is reported as ordinary income, and the strike price is your cost basis in the stock holding. The growth over the exercise period is taxed at capital gains rates.

Please consult a tax professional or a financial advisor for advice on your personal financial situation.

Restricted Stock Units (RSUs)

RSUs are another way an employer can grant company shares to employees. The units are 'restricted' because they are subject to a vesting schedule, which can be based on length of employment or on performance goals.

Upon vesting, RSUs typically convert to shares of common stock (representing actual ownership within a company and grant the same rights and privileges that any owner of that share class would have). This could include dividend distributions (should the company issue dividends) or the right to vote at the annual meeting. In other words, upon vesting RSUs become the equivalent of shares that anyone can buy in the open market- i.e. through your Fidelity or E*TRADE account.

Unlike stock options, RSUs represent actual ownership and are typically issued at zero cost (no acquisition cost) to the employee. Stock options can go 'underwater' and lose all practical value with a falling stock price, but RSUs are almost always worth something as long as the company of the underlying stock has value. Even if the company's stock price drops dramatically, you still took ownership at zero cost (versus just the right to buy with an option).

Tax Planning for RSUs:

You're taxed on the market value of your stock when you receive the shares at vesting. The value (Shares x Current market price or vest price) will be reported as ordinary income on Form W-2 in the year they are received. Shares are withheld by your company to pay taxes (federal, state, local, Social Security, Medicare).

Key points of RSUs

- **Restricted stock units (RSUs) are a way your employer can grant you company shares.**
- **RSUs are nearly always worth something, as long as the underlying company has value.**
- **RSUs must vest before you can receive the underlying shares. Job termination usually stops vesting.**
- **With RSUs, you are taxed when you receive the shares. Your taxable income is the market value of the shares at vesting.**

Please consult a tax professional or a financial advisor for advice on your personal financial situation.

Restricted Stock Units (RSUs) (cont)

Consider the following example below. 4,000 RSU shares are granted with a four-year vesting period, and 25% of the issuance vests each year. Assuming a 40% tax rate (federal, state, local, Social Security, Medicare), the after-tax market value is $66,000 with 2,400 shares remaining:

Vesting date	Shares	Vest price	Market value	Taxes	Shares withheld	Market value (est.after tax)	Shares (est. after tax)
Year 1	1,000	$20	$20,000	$8,000	400	$12,000	600
Year 2	1,000	$25	$25,000	$10,000	400	$15,000	600
Year 3	1,000	$30	$30,000	$12,000	400	$18,000	600
Year 4	1,000	$35	$35,000	$14,000	400	$21,000	600
Total value			$110,000	$44,000	1,600	$66,000	2,400

Now let's say that five-years after the initial vesting, you decide to sell the remaining 2,400 shares of your stock for cash. The stock price is $50/share on the day of the sale. The RSUs are fully vested, and each issuance has met the holding period requirement of 12 months to receive favorable long-term capital gains tax treatment (15-20%) on any proceeds when the shares are sold.

Employee Stock Ownership Plan (ESOP)

An ESOP is a type of employee benefit plan where an employee's company sets up a trust fund, into which it contributes new shares of its own company stock or cash to buy existing shares for the employee's benefit. The contribution is pretax.

Employees pay no tax on the contributions to their ESOP. Depending on the specific plan, an employee may be able to roll over their shares tax free to a qualified retirement plan (IRA, 403b, 401k etc.) or take a taxable distribution of their shares, owing income tax on the full value of the stock. If a taxable distribution is taken before 59 ½, the shares would typically be subject to a 10% tax penalty.

Please consult a tax professional or a financial advisor for advice on your personal financial situation.

Employee Stock Ownership Plan (ESOP) (cont)

When you think of stock, you normally think of a publicly traded companies, but ESOPs can also be used for private companies too. Since they are not publicly traded, private companies must have an annual outside valuation to determine the price of their shares. To sell the stock, the employee can either sell their shares back to the company or if the company is sold, the employee receives cash in lieu of their shares. This payment is tax deferred. As stated above, this can be rolled over to a qualified retirement plan like a 401k, Rollover IRA, converted to a Roth IRA, or taken as a distribution (taxes and penalties apply if taken before 59 ½).

Employee Stock Purchase Plan (ESPP)

The ESPP allows you to purchase shares of your company's stock, usually at a discount, with funds deducted from your paycheck. ESPP shares are yours as soon as the stock purchase is completed. You can hold on to the shares as part of your portfolio or sell them at your discretion (subject to any holding period requirement). Typically, only full-time, permanent employees are eligible to participate in an ESPP program.

ESPPs allow employees to buy company stock without having to exercise the transactions themselves. These plans are like other types of stock option plans in that they promote employee ownership of the company, but do not have many of the restrictions that come with other stock option arrangements previously discussed. ESPPs can be qualified or nonqualified. Qualified ESPPs are the most common type of plan.

Tax Planning for ESPPs

When it comes to the tax treatment of ESPPs (and many other types of stock option plans) timing is everything. The sale will be designated as either qualifying or disqualifying depending on when you sell your shares. Please consult with your financial planner.

Please consult a tax professional or a financial advisor for advice on your personal financial situation.

Where to Go From Here

Still confused about employee stock options? Our team of financial advisors are happy to answer your questions any time.

Visit **paynecm.com/financialplan** to see if you qualify for a complimentary financial review today

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