Money Matters

August 4, 2015

Skloff Financial Group Question of the Month: Employee Stock Options – Use Them or Lose Them

By Aaron Skloff, AIF, CFA, MBA

Q: My employer has awarded me numerous stock options over the years. When can I exercise these employee stock options and what are the tax ramifications?

A: The Problem. Many employers award stock options to attract and retain employees. Unfortunately, many employees do not truly understand the different types of options they are awarded, their tax ramifications and how their terms can change.

The Solution – Understanding Employee Stock Options. An employee stock option is a right, but not a requirement, to purchase a stock at a specific price and specific time. Before you can exercise your options they must vest. Vesting is the right to buy shares from your employer over a set period of time, as defined in your grant agreement, before the options expire. Not all employee stock options are created equal. Those differences could leave you quite wealthy and the I.R.S. disappointed or leave you somewhat wealthy and the I.R.S. happy. Let's look at both types of options.

Incentive Stock Options (ISOs). In general, you do not have to pay taxes on Incentive Stock Options (ISOs) when they are exercised. You are subject to the 20% maximum capital gains tax rate instead of the maximum 39.6% maximum income tax rate (sorry I.R.S.) if:

1. You sell the ISO shares more than two years after the options grant date and
2. More than one year after you bought the stock shares by exercising your ISOs

Important Note: You may be subject to Alternative Minimum Tax (AMT) when you exercise – so, speak with your Financial Advisor before exercising your options.

ISO Example. On July 1, 2015, you receive an ISO giving you the right to purchase 100 shares of ABC stock for $10 per share. You exercise your ISO on August 2, 2016, when the market price is $15. Your cost basis per share becomes $10. On September 3, 2017, you sell your ABC stock for $30 a share. The date of sale is more than two years after the July 1, 2015, grant date and more than one year after the August 2, 2016, exercise date. By meeting both of the conditions outlined in the paragraph above, your $2,000 profit ($30 X 100 shares - $10 X 100 shares) is a long term capital gain, subject to the 20% maximum capital gains tax rate (sorry I.R.S.).

Nonqualified Stock Options (NQSOs). In general, you pay taxes when you exercise your option. The amount of tax owed is based on your gain, the difference between your option's exercise price and the price of the stock when you exercise your shares. At this point, you can sell the stock. If you sell the stock in one year or less you can be subject to the 39.6% maximum short term capital gains rate (equal to the maximum income tax rate). If you sell the stock after one year you can be subject to the 20% maximum capital gains tax rate (sorry I.R.S.).

NQSO Example. On July 1, 2015, you receive an NQSO giving you the right to purchase 100 shares of ABC stock for $10 per share. You exercise your NQSO on August 2, 2016, when the market price is $15. You are now subject to a maximum income tax rate of 39.6% on the $500 gain ($15 X 100 shares - $10 X 100 shares). Your cost basis per share becomes $15. On September 3, 2017, you sell your ABC stock for $30 a share. The sale date is more than one year after the August 2, 2016 exercise date, subjecting you to the 20% maximum capital gains rate (sorry I.R.S.).

ISOs are generally more attractive than NQSOs, since they do not generate taxes when they are exercised. That said, the two year wait might occur when the stock price is in a downward spiral. **Don't Let the Tax Tail Wag the Investment Dog**. Although tax management is critical, it is not paramount to maximizing profit.

Expiration Dates. Since options are often awarded at different times they have different expiration dates. A very valuable option leading up to its expiration date is worthless the day after its expiration date. So, exercise diligence when exercising your options.

Often Overlooked. Many stock option plans have clear language defining your rights about exercising your options upon termination from the company. For example, upon termination (other than by reason of death or disability) you have up to 90 days from the date of termination to exercise all or any part of your options that were exercisable at the date of termination. Severance from a job can be an emotional time, when you may overlook a material part of your wealth – your employee stock options.

Action Step – Understand Your Options
Work closely with your Financial Advisor to understand and manage your employee stock options.

Aaron Skloff, Accredited Investment Fiduciary (AIF), Chartered Financial Analyst (CFA), Master of Business Administration (MBA) is CEO of Skloff Financial Group, a Registered Investment Advisory firm specializing in financial planning, investment management and benefits for small to middle sized companies. He can be contacted at www.skloff.com or 908-464-3060.