

Understanding Employee Stock Option Plans

The boom days of the 1990s may be over, but stock option programs continue to be popular with public and private companies. Employees certainly can benefit from them, if they take some time to learn the basics.

Callout:

Most stock options have an exercise period of 10 years; that is, you have 10 years from the time you receive the options to actually purchase the stock.

Social Media Message:

Got stock options from your employer? Be sure to know the rules before exercising.

In the dot-com boom years of the 1990s and early 2000s, many companies made liberal use of employee stock option plans (ESOPs) to both reward and retain valued staff, from executives to temporary administrative help. While the current economic climate has produced fewer "company stock millionaires" these days, stock option programs continue to be popular with public and private companies. And employees certainly can benefit from them, if they take some time to learn the basics.

What Is a Stock Option?

If you've been granted stock options, you've been given the right to purchase shares of your company's stock at a certain price under certain conditions set by company management.

- If you have **immediate options**, you can purchase your allotted shares at any time.
- If your options are **vested**, you can only purchase a set number of shares after you've worked at the company a certain period of time.
- If your options are **performance-based**, they will vest once certain goals are met.

The two most common types of ESOPs are incentive stock option (ISO) and nonqualified stock option (NSO) plans. Usually, key executives are granted ISOs, while less senior employees are given NSOs. The chief difference between the two is tax treatment.

- An ISO can be taxed under long-term capital gains, assuming the employee holds the stock for at least two years from the option grant date and one year from the exercise date. They are also taxed only when the stock is sold, making them tax-deferred plans. Note that ISOs can trigger the alternative minimum tax (AMT).
- NSOs are taxed as both income and capital gains -- and the tax is owed once the options are exercised. This is an important consideration to anyone who is thinking of exercising options. If you don't have enough cash on hand to cover the tax bill, you may need to sell shares you've just purchased to cover the costs.

Exercising Options

Most stock options have an exercise period of 10 years; that is, you have 10 years from the time you receive the options to actually purchase the stock. You are not obligated to buy any shares, particularly if your company's stock price is trading below your set exercise price. If you don't make a purchase during the exercise period, your options will expire worthless.

Companies have the flexibility to exchange option grants if its stock has been negatively affected by market activity. For example, if your stock options are priced at \$25 a share and your company stock has been trading at only \$20 a share for a prolonged period, the company may exchange your \$25 strike price options for a new set that gives you a lower strike price.

If you are participating in an ESOP, be sure to consult with a financial and/or tax professional who can help you decide when to exercise your shares and how to deal with the tax consequences.

Because of the possibility of human or mechanical error by McGraw-Hill Financial Communications or its sources, neither McGraw-Hill Financial Communications nor its sources guarantees the accuracy, adequacy, completeness or availability of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. In no event shall McGraw-Hill Financial Communications be liable for any indirect, special or consequential damages in connection with subscriber's or others' use of the content.

###

© 2011 McGraw-Hill Financial Communications. All rights reserved.

September 2011 — This column is provided through the Financial Planning Association, the membership organization for the financial planning community, and is brought to you by Douglas Wm. Elliott, a local member of FPA.