

Stephanie Kelly

Senior Vice President, Wealth Management
Corporate & Executive Services
320 Park Ave., 12th Floor // New York, NY 10022
212.314.0455
raymondjames.com/skelly

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UNDERSTANDING COMPENSATORY STOCK OPTIONS

A review of the terminology, exercise techniques and tax treatment of stock options

Many employers utilize stock options as a form of compensation to retain and attract talented employees. Stock options give the employee the ability to participate in the growth of their company's value. However, before a decision to exercise is made, it would be beneficial to know the basics about stock options and their potential tax implications. This white paper provides an introduction.

STOCK OPTIONS

There are two types of stock option grants: incentive stock options (ISOs) and non-qualified stock options (NQSOs). While the two styles of options share common terminology, the tax and planning considerations differ widely.

INCENTIVE STOCK OPTIONS

ISOs, sometimes referred to as qualified stock options, provide favorable tax treatment to the option holder as long as certain requirements are met. In fact, no tax is assessed when an ISO is granted and, under the regular tax system, no tax is assessed when an ISO is exercised.



KEY TAKEAWAYS

There are two types of stock option grants: incentive stock options (ISOs) and non-qualified stock options (NQSOs). The tax and planning considerations differ widely between the two.

ISOs provide favorable capital gains tax treatment to the option holder, while ordinary income tax is assessed upon the exercise of NQSOs on the value between the strike price and the fair market value of the stock.

Exercising stock options can be funded out-of-pocket, through either a cash or cashless exercise, or a stock swap.

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However, when the underlying stock is ultimately sold under the regular tax system, the value between the strike price and the sale price is taxable to the option holder as long-term capital gains if the requirements set forth in Internal Revenue Code Section 422 are satisfied. Those requirements include:

- The option must be exercised within 10 years of the grant date.
- Only the individual who is granted the ISO may exercise it. An ISO may be transferred only at death to the optionee's estate or beneficiaries.
- The maximum total value of stock (determined as of the grant date) that is exercisable during any one calendar year is \$100,000.
- The stock acquired through the exercise must be held for at least two years from the grant date and one year from the time it is exercised.

Stock that is acquired through the exercise of an ISO and is not held for the time period set forth in IRC Section 422 noted above will be considered a disqualifying disposition and ordinary income rates will be assessed on the value between the strike price and sale price, reverting to the tax treatment of non-qualified stock options.

NON-QUALIFIED STOCK OPTIONS

NQSOs do not have any requirements to fulfill and are much more straightforward than ISOs.

Like ISOs, no tax is due when NQSOs are granted. However, unlike ISOs, ordinary income tax is assessed upon the exercise of NQSOs on the difference between the strike price and the fair market value of the stock on the date of exercise. When the stock is ultimately sold, capital gains rates will apply if the sale price is greater than the fair market value on the date of exercise.

Typically, employers will withhold taxes at a predetermined rate when employees exercise NQSOs. In some situations, if non-employees receive NQSO awards, the employer may not automatically withhold taxes upon the exercise of the option award. These individuals will receive a 1099 from the company at the end of the tax year disclosing the compensation income recognized through the option exercise, and the individual must be prepared for the tax payment due in association with this income at tax time.

TALK TO YOUR TAX ADVISOR

In some circumstances, when an ISO is exercised, the option holder may be subjected to the alternative minimum tax (AMT). The difference between the strike price and the fair market value on the date of exercise is considered an AMT preference item and is added to the option holder's income for the purpose of calculating AMT. A tax professional should be consulted prior to exercising ISOs to discuss the potential impact of AMT.

EXERCISING STOCK OPTIONS

When employer stock options are exercised, the individual exercising the option is required to pay the company, often via a plan administrator for the exercise. An amount equal to the strike price will be due for each share that is acquired.

In the case of non-qualified stock options, federal, state, local and FICA taxes will also be due upon exercise. These compensation taxes will be assessed on the option's intrinsic value, or the amount by which the underlying stock's price exceeds the option's strike price.

Consequently, the cost of exercising employee stock options can be substantial. However, there are methods of exercising that do not require the option holder to pay "out-of-pocket."

CASH EXERCISE

In a cash exercise, the individual deposits sufficient cash with the option plan administrator to cover the strike price of the option and any other costs associated with the exercise, including appropriate tax withholding and any fees.

CASHLESS EXERCISE

In a cashless exercise, concurrent with the exercise, the executive sells at least enough of the newly acquired stock to pay the cost of the exercise – including taxes – referred to as a "cashless exercise – sell to cover." The remaining shares can be retained or sold, and represent the net value owned by the option holder. When the individual sells all the shares underlying the option grant, it is referred to as a "cashless exercise – sell all."

STOCK OPTIONS TERMINOLOGY

Grant date – the date on which the option is awarded to the employee

Vesting date – the date on which the option grant becomes exercisable by the employee

Expiration date – the date on which the option grant is no longer valid

Underlying shares – the number of shares that can be acquired through exercise of the option

Strike price – the price that must be paid to exercise the option and acquire the underlying shares, most commonly the stock's market price at the time of grant

Exercise – the act of making use of the right afforded by an option grant that requires the delivery of cash in exchange for shares

STOCK SWAP

In a stock swap, the option holder pays for the exercise with shares of company stock rather than cash. In order for this to be a viable alternative, the plan must allow stock swaps as a method of exercising and the option holder must own a sufficient number of shares outright. Additionally, the benefits of a swap apply primarily to ISO grants as opposed to NQSO grants.

When a stock swap is completed, the option holder will receive the number of shares specified in the option grant. Of the newly acquired shares, a number of shares that equals the amount of shares swapped to fund the exercise will retain the cost basis and acquisition date of the swapped shares. All of the remaining shares will have a cost basis of zero and an acquisition date equal to the exercise date.

WE'RE HERE TO HELP

When managed and exercised correctly, stock options can be a source of great wealth creation. The Raymond James Executive Compensation Services team has the experience and resources to help you make the most of your equity compensation to benefit your long-term financial plan and minimize your tax liability. We welcome the opportunity to assist executives like you with stock option decisions.

Please contact our team at **212.314.0455** with any questions.

You should discuss any tax or legal matters regarding compensatory stock options with your tax or legal professional.



STOCK SWAP EXAMPLE

An employee has an ISO for 5,000 shares of XYZ stock with a **strike price of \$25**. The employee owns 2,500 shares of XYZ outright (with a cost basis of \$5 and an acquisition date of 1/1/2001) and the stock is currently trading at **\$50 per share**.

The cost to **exercise** is **\$125,000 (5,000 shares x \$25)** and the employee **swaps** the shares owned outright (**2,500 x \$50 = \$125,000**) to pay for the exercise.

The newly acquired 5,000 shares have the following cost basis:

- 2,500 shares with a cost basis of \$5 and an acquisition date of 1/1/2001
- 2,500 shares with a cost basis of \$0 and an acquisition date equal to the exercise date

For option holders who own a significant amount of their employer stock outright, a **stock swap** may be an effective way to address concentration risk.

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880 CARILLON PARKWAY // ST. PETERSBURG, FL 33716 // 800.248.8863
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