Compensation Concepts: Stock Options

Compensation Concepts adds clarity to complex compensation issues, helping advisors guide clients toward smarter decisions.

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Stock Options

Stock options are a form of compensation that gives employees the right, but not the obligation, to buy company stock at a fixed price after a certain period.

The key components of a stock option are:

- **Grant**: The company gives the employee the option to buy a certain number of shares at a set price, typically subject to a vesting schedule.
- **Vesting**: The employee earns the right to exercise options over time.
- **Exercise**: Once vested, the employee can buy the shares at the exercise price (also called the strike price or grant price).
- **Sale**: The employee can sell the shares at the current market price, ideally higher than the exercise price to realize a profit.

There are two types of stock options: incentive stock options and non-qualified stock options.

Incentive stock options (ISOs):
ISOs have tax implications that can be advantageous—if managed correctly. There are no immediate tax consequences for the employee when ISOs are granted; when ISOs are exercised, income tax is generally not triggered. The difference between the exercise price and the fair market value (FMV) of the stock on the exercise date is referred to as the "spread." Typically, if shares are held for at least one year after exercising the options and two years after the grant date, the sale is considered a qualifying disposition and the difference between the exercise price and the FMV at the time of sale will be taxed as long-term capital gains.

If shares are sold before these holding periods are met, the sale is considered a disqualifying disposition, and the spread at exercise is taxed as **ordinary income**, with any additional gains taxed as capital gains.

The spread is considered an "adjustment" for alternative minimum tax (AMT) purposes. This can cause a taxpayer to become subject to AMT if it pushes taxable income above the AMT exemption amount. Having the spread treated as an AMT adjustment can be avoided by selling the shares in the year of exercise.

While ISOs provide the benefit of tax-advantaged treatment if held properly, they can complicate tax situations, particularly regarding AMT. It's often advisable to exercise them early in the year for maximum flexibility and to consult with a tax professional to navigate these complexities and optimize tax strategies.

Non-qualified stock options (NQSOs)
NQSOs are more common than ISOs. When NQSOs are granted, there are no immediate tax consequences for the employee. When NQSOs are exercised, the spread is taxed as ordinary income. Any future gains or losses on the stock are treated as capital gains or losses. While NQSOs have fewer tax benefits than ISOs, they do give taxpayers the ability to time the recognition of income.

Stock options can be a great way for employers to attract and retain talent, but it's important that employees understand the potential for complicated tax implications.

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