NONQUALIFIED STOCK OPTIONS

STONEHEARTH CAPITAL MANAGEMENT

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WHAT ARE THEY?

A non-qualified stock option (NQSO) is a type of stock option that can be granted to employees, as well as contractors and consultants, as part of an equity compensation plan offered by employers. Employee stock option plans are implemented by employers as a type of benefit to compensate and incentivize employees. These plans provide an opportunity for employees to own shares in the company and benefit from potential increases in the company stock price. Nonqualified stock options do not qualify for special tax treatment, like incentive stock options (ISOs), another popular type of equity compensation. However, similar to ISOs, nonqualified stock options provide the right to buy a set number of company shares at a specified price during a specific period of time.

There are a few key terms used with NQSOs to define how a company's specific stock option plan has been designed.

- **Grant** – When a company issues NQSOs to an employee, this is referred to as a Grant and the specific date that the options are granted is referred to as the Grant Date.
- **Exercise Price** – Also referred to as the Strike Price. This is the price that an employee would pay to purchase the company shares of stock. This price must be equal to the fair market value of the company's stock on the Grant Date.
- **Spread** – The difference between the value of the stock when you exercise and the exercise price. For example, if you have an NQSO with an exercise price of $3.00 per share and you exercise an option when the stock price is $8.00 per share, the spread is $5.00 per share.
- **Vesting Period** – The period after the Grant Date that an employee must wait to exercise their options. Vesting is defined separately for each grant with a vesting schedule. For example, a grant of 1,000 NQSOs may have a four-year vesting schedule with 25% of the options vesting each year.
- **Exercise Date** – The date that an employee elects to exercise their NQSOs. Exercising a stock option refers to purchasing the company's stock at the exercise price set at the grant. This date defines the starting point for their ownership of the stock.
- **Expiration Date** – The last date that an employee can exercise a stock option. All stock options have an expiration date, typically 10 years after the grant date. Note that certain events, such as termination or retirement, may accelerate expiration.

HOW ARE THEY TAXED?

With nonqualified stock options, there are no taxes due at the grant date or vesting date. When you exercise a NQSO, you are electing to purchase a share of company stock at the predetermined exercise price. The exercise of an NQSO is important as it determines your original purchase date and triggers a taxable event.

When you exercise NQSOs, you will owe ordinary income tax on the difference between the grant price and the stock's price on the date of exercise. This difference (the spread) is considered ordinary income, subject to federal, state, Social Security, and Medicare taxes. In some cases, you can immediately sell some of the shares you just purchased to cover the taxes. This is commonly referred to as "Sell to Cover," and you should check with your plan to see if this is available to you.

The market price of the shares on the exercise date determines your tax basis. If you sell the shares immediately upon exercise, you will have ordinary income taxes noted above, but will not incur additional taxes. However, if you hold the shares after exercise, you will pay capital gains taxes on any additional gain, at the short-term or long-term rate, depending on how long you hold your shares after exercise. (You may have a capital loss if sold below the market price at exercise).

Let's look at an example:

- Number of options: 100
- Exercise price: $10
- Fair market value when exercised: $30
- Spread is $20/share ($30-$10)

If you decide to exercise all 100 options, your total cost is $1,000 (100 share options x $10 exercise price). You will owe ordinary income tax on the difference between the grant price ($10) and the full market value at the time of exercise ($30). In this example, $20 p/share, or $2,000. Your tax basis is now $30 p/share.

Sell shares within one year after exercise - When you sell shares within one year after exercise, any gain will be taxed as short-term capital gains (or loss if sold below the market value at exercise date).

In our example, your basis after exercise is $30/share. If you sell all 100 shares at $45/share, your total short-term gain is $1,500 ($45 - $30 = $15 x 100 shares).

Sell shares more than one year after exercise - If you hold the shares for more than a year after the exercise date, any additional gain above your tax basis will be taxed as long-term capital gain (or loss). In our example, if you sell all 100 shares at $65/share, your total long-term gain is $3,500 ($65 - $30 = $35 x 100 shares).

PLANNING CONSIDERATIONS

With careful planning, nonqualified stock options can provide significant economic gain. It's important to be aware of the provisions of your company's equity compensation plan so you are aware of key features such as the vesting schedule and what happens to your options at certain life events, like retirement or a company merger. Tracking your grants is also important. It is common for employees to receive multiple grants of NQSOs over consecutive years, resulting in hundreds or sometimes thousands of options with various vesting schedules and expiration dates.

As outlined above, taxes play an important role in stock option planning. Notably, with NQSOs, the taxes that are withheld when you exercise options are typically based on flat tax rates that are not based on your actual federal tax bracket. These are known as supplemental income rates and are either 22% (or 37% for amounts over $1 million in a calendar year).The taxes withheld at exercise may not meet your actual tax obligation and you might have to make an estimated tax payment.

There are also various schools of thought related to when to exercise. Maybe you exercise earlier when the stock price is lower and hold the stock, attempting to shift future appreciation to capital gain. However, this may not be the best plan in all cases depending on your specific financial condition and the expected appreciation rate of the stock.

Another consideration is to be aware of concentration risk, which can arise from an increase in the amount of company shares you own from exercising stock options. It is advised to consider an optimal amount of company shares that you own as a percentage of your overall portfolio.

Finally, remember that there is not one plan that will work for all people with stock options. You will want to develop any planning around your employee stock options within the context of your overall financial plan and your personal financial goals.

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