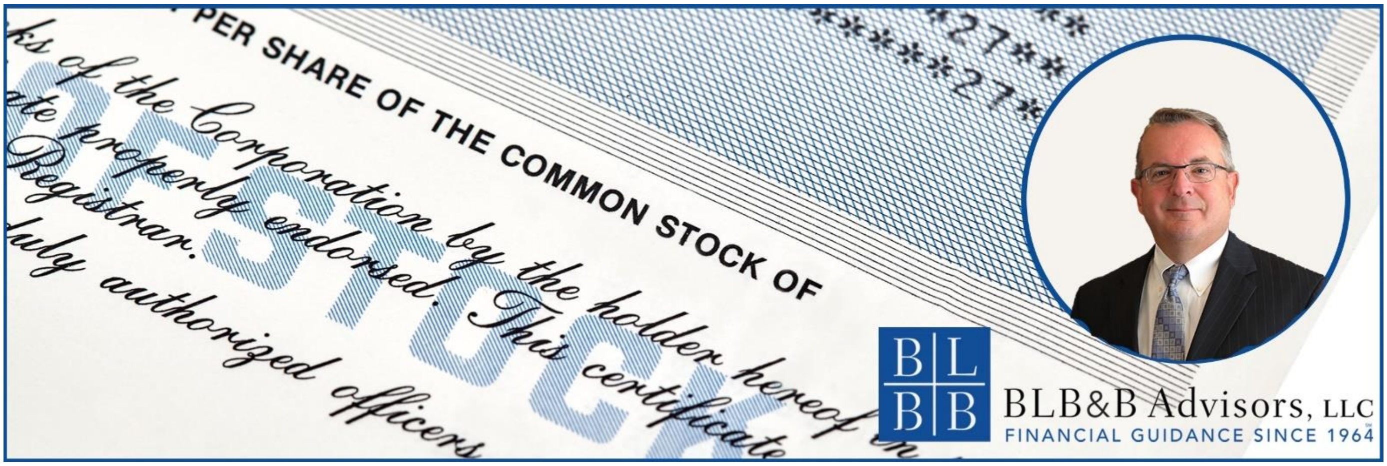

What should I do with my company stock options?

Are you fortunate to work for an employer that has included a stock option plan as part of your overall compensation package? If yes, you may be sitting on a valuable holding. At the same time, however, you also may be facing some relatively complex decisions around how to handle these options and manage any possible tax consequences. Although stock options can prove to be quite lucrative over time, they may cause option holders to stress over whether they are making smart decisions about how to handle them. If you find yourself in this situation, your BLBB financial advisor can help you evaluate the pros and cons of the various courses of action open to you and factor these options, and thus your exposure to your company's stock, into the overall management of your investment assets. Keep in mind, that you may have a concentrated stock position because of your options, and it is important to not only manage (and perhaps even ease) this concentration but also to manage your other assets around this concentration.

At its most basic, an employee stock option gives you the right to purchase a specified number of shares of company stock at some defined time in the future and for a predetermined share price which is usually referred to as the exercise or strike price. It is also fairly common for your stock options to come with a vesting schedule. This means the options are not immediately usable – e.g., you can't exercise them or exchange them into company stock until the vesting period has passed. If you so choose, and once any vesting period has passed, you can exercise some or all of your options, but you are not obligated or required to do so.

Typically, option holders are afforded a specific window of time (usually 10 years) during which they can decide when, and if, to exercise their options. This allows you to benefit from any stock price appreciation without the need for an immediate cash outlay. You should note, however, that both the expiration date and the vesting schedule for your options could change if your employment status changes (you resign, retire, become disabled, etc.)

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- When a **stock's price exceeds the option's exercise price**, the option is considered 'in the money.' This means you're able to exercise your option and buy the stock at a discount to its current price.
- When an option's **exercise price is greater than the stock price**, the option is 'out of the money'. In this case, you would most likely allow it to expire without exercising (unless it's a privately held company, and exercising the option is the only way to acquire shares you think will be more valuable in the future).
- The taxation of stock options can be confusing. There are 3 key dates relevant to your tax calculation options:
  - When your company granted you the options
  - When you exercised these options
  - How long you held the company stock shares before selling them

In many cases, holding onto your options may be more advantageous than exercising them and owning the stock outright. This strategy allows you to defer a large amount of income and control when you ultimately recognize it. And, it affords you protection against potential stock losses (since you can simply opt not to exercise the option if the share price declines).

However, if you do exercise your options, you may be able to mitigate the tax liability. This is because any growth in value that occurs before you exercise your options is often taxed as ordinary income, whereas 'post-exercise' growth is generally taxed as capital gains. With a long-term capital gains tax rate of 15-20% (depending on your tax bracket), compared to a 37% top tax rate for ordinary income, the tax savings could be substantial.

Understand the specifics pertaining to your options

Whenever you're granted company stock options, you will receive a *Stock Option Grant Certificate and Agreement* detailing:

- Whether the granted options are incentive stock options or nonqualified stock options
- Specifics of the grant (e.g., number of shares, exercise price per share, grant date and expiration date, as well as any associated vesting schedule)
- Any required tax withholding
- Any restrictions on transferability and/or terms (e.g., what happens to your options if the company is sold/merged or if your employment is terminated, etc.)

2 types of employee stock options

While similar, **incentive stock** options ("ISOs") and **nonqualified stock** options ("NQSOs or NSOs") are subject to different tax treatments (including ordinary income, long- or short-term capital gains, alternative minimum tax), exercise timetables, and allowable methods of funding the purchase price.

In addition, executive and director level employees may receive option grants for Restricted Stock Units ("RSUs"). RSUs are stock that is only available to key employees and "restricted" based on a set vesting schedule which could include reaching a certain length of employment or performance benchmark. RSUs may cause additional concentration in your company's stock that should be taken into consideration.

Create a plan to manage your options

Your stock option strategy needs to be objective and unbiased—not driven by a sense of company loyalty. Decisions about whether and when to exercise should always be based on company fundamentals, as well as your own investment goals, risk tolerance, and current portfolio allocation.

1. Start by considering how best to optimize and protect your wealth based on your goals and risk tolerance. Does it make sense to increase your company stock holdings, or are you taking on too much risk with a concentrated stock position that needs greater diversification?
2. If you decide to exercise your options and purchase the stock, then you'll need to identify the best time. Make sure you know the timetable of your company's plan, since most options can be exercised over a period of years.
3. Consider any potential or anticipated short-term cash needs you might have. The greater those needs, the more you may want to consider selling your options and pocketing the profits.
4. Lastly, factor in the expected future performance of both the stock market and the company. If you strongly expect the stock to appreciate significantly, consider deferring the exercise of your options to help lessen portfolio risk and maximize returns (assuming your portfolio is adequately diversified).

When exercising stock options, the easiest strategy is to just hold on to them if you believe the value of the stock will continue to increase over time. It's a simple way to put off dealing with any tax implications of exercising your options and allows more time for the stock to appreciate and increase your potential gains. Keep in mind, however, that your stock options will expire at some predetermined point in the future—after which they have no value. Alternatively, you can:

- Pay the option cost to buy the shares with either cash or a margin loan, and then retain the stock shares in your portfolio (exercise and hold);
- Pay the option cost to buy the stock and then sell just enough shares to cover the exercise price and any taxes due (sell to cover); or
- Assuming your employer will allow it, use stock shares you already own to cover the exercise cost less any fees or transaction costs (cashless exercise).

In situations where you have a need for liquidity or diversification, however, you may want to consider exercising the options and immediately selling the shares (exercise and sell).

Seek out professional advice

Before deciding whether to exercise any stock options—as well as when and how to engage in the transaction—make sure to sit down with both your tax advisor and your BLBB Financial Advisor (215-643-9100) to review the pros and cons of various strategies. In addition to assessing how various option exercise approaches may impact your tax liability, you'll want to carefully review your overall portfolio holdings to ensure you're maintaining an appropriate level of risk and not holding too much of your wealth in company stock. Through our financial planning process, we can assist in identifying how concentrated your stock position may be and how we can more effectively manage around any concentrations you may have. Also, do not wait until your options are about to expire to develop your stock options strategy. It is quite possible your tax advisor could suggest you spread the tax, or cost consequences of exercising, over more than one tax year. Using sophisticated tax planning software, we may also be able to assist in the analysis of tax issues associated with the exercising of options and illustrate a variety of “what if” scenarios over multiple tax years that may be helpful in the decision-making process. If you are up against a rapidly approaching option expiration deadline, you’ve limited your ability to strategize.

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