Stock Options

Stock options as a form of compensation has gained popularity in the past decade or so. Although this term may connote different things, there are several forms of stock options. Some of the common ones are:

1. **Stock Grants**: Stock grants are "free" stocks given to current or prospective employees to attract or retain talent. For example, a company may give Executive A 1000 stocks as an incentive for the person to stay with the company. The executive may sell the stock to anyone he/she wishes and pocket the money. If the stock sells for $45 per stock, the executive can sell the 1,000 stocks and earn $45,000 instantaneously. In this form, there is no risk involved to the executives as the stock price multiplied by the number of stocks equals the cash compensation.

2. **Stock Bonuses:** Stock bonuses are typically granted in lieu of cash. For instance, a company might design a stock bonus plan such that "If the company's stock does not fall below $50 during the next 52 weeks, the CEO will get a stock bonus of 200,000 stocks". Here the stock bonus is contingent upon the stock price being at or above $50 for the next 52 weeks. The main goal of such a program is to ensure that the stock prices are stable across a certain period of time. Just as stock grants, the employee can sell the stock at any time he/she wishes and keep the proceeds as compensation.

3. **Employee Stock Ownership Plans (ESOPs):** ESOPs are in reality a "profit-sharing retirement plan". In such a system, the company contributes to the employee retirement plan in the form of stock rather than cash. For example, if the company's retirement plan states that the company would contribute 6% of employee compensation towards a retirement plan, the company would compute 6% of the total eligible employee compensation and issue stocks in favor of the fund. For example, if the stock price is $40 per stock and 6% of the employee compensation works out to $1,000,000, then the company would issue 25,000 stocks to ESOP plan ($1,000,000 divided by 40). However, unlike stock grants or stock bonuses, employees cannot sell the stocks immediately and cash them. Being a retirement plan, the employee can only cash the accrued amount when he/she retires or when he/she quits employment subject to vesting.

4. **Stock Options**: Stock options grant select employees the "right" to "buy" the stock at a "predetermined" price within "a certain period of time". Whether to "exercise" the option (or buy the stock) is entirely up to the employees. That's why it is known as "stock options". It grants the employees the "right" to buy the stocks. If the employee fails to exercise the "right" he/she forfeits the right. An example of a stock option might be: On March 25, 2003 Chris is granted an option to buy up to 2,500 stocks at the current stock price of $48 per stock that he can exercise within a period of 3 years (He must exercise the option to buy the stock by paying the company 2,500 times $48 on or before March 24, 2006). If the stock price goes up to $75 on March 22, 2005, then he can buy 2,500 stocks at $48 per stock as stated in the option and can sell it at $75 and keep the difference as his gain. The rest of the notes here will elaborate on "stock options" as opposed to stock grants or stock bonuses or ESOPs.

Types of Stock Options:

Stock options can be classified as: (1) **Qualified Stock Options** (also known as Incentive Stock Options, I will call this as ISOs for short from now on); and (2) **Non-Qualified Stock Options**.

Incentive Stock Options: For ISOs, the IRS (Internal Revenue Service) has very strict guidelines. Any stock option that meets these guidelines will be known as ISO and gets favorable tax treatment for the individual employee. So what are these rules? Let us take one-by-one.

1) 1) Granted Only to Employees: ***ISOs can be granted only to employees***. For example, if I am asked to sit on the Board of Directors of a company, I am not an employee of the company because my employment is with UHV. If the company grants me a stock option, it cannot be treated as an ISO. However, if the company grants a stock option to its Chief Financial Officer who is an employee of the company, that would qualify as an ISO.
2) 2) Written Plan Approved by the Shareholders: ***For a stock option to be considered as a qualified stock option, the stock option plan must be in writing and must be approved by the stockholders within 12 months*** (12 months before or after) of the option. For example, if a company grants a stock option to one of its employees on March 26, 2003, the plan must have been approved by shareholders on or after March 27, 2002 or must be approved on or before March 25, 2004.
3) 3) Option Price cannot be less than the Fair Market Value (FMV): ***For a stock option to be considered an ISO, the "option price" – option price is the price at which an employee is allowed to buy the stocks – cannot be less than the fair market value***. FMV can be obtained in two ways: (1) For a publicly traded corporation, the FMV is the "average stock price at which the stock is traded in the market (e.g., NASDAQ, NYSE) on the date the stock is granted". (2) For a privately held corporation, the FMV is the *price at which the stock would have traded* in the market as if it were a publicly traded corporation. This requires an estimation of the price that can be done by financial analysts. For example, if the stock trades at $22 on March 26, 2003 in the stock exchange, then the option price must be $22 or more to qualify it as an ISO.
4) 4) Holding Time: ***For a stock option to be considered an ISO, the grantee (the employee) must hold the stock for a minimum period of time before selling it***. There are two rules here: (1) The employee cannot sell the stock within two years from the date the option is granted. For example, if the employee is granted a stock option on March 26, 2003 (the grant date or option date), he/she cannot sell it on or before March 26, 2005. (2) The employee, after exercising the option (exercise date), cannot sell the stock within one year of exercise. For example, if the employee was granted stock option on March 26, 2003 (option date) but he/she actually exercised the option on April 25, 2006 (exercise date), he/she cannot sell the stock on or before April 25, 2007 (disposal date). Both of these conditions must be satisfied for an option to be considered as an ISO.
5) 5) Duration of the Option: ***For a stock option to be considered, the option must be exercised within 10 years of the option date***. For example, if the option is granted on March 26, 2003, the employee must exercise the option on or before March 25, 2013. If

the company allows the employee to exercise the option on or after March 26, 2013, it would be treated as a non-qualified option.

6) 6) Non-Transferability of Options: ***For an option to be considered an ISO, the option cannot be transferred to anyone else other than the employee*** (upon his/her death, the option transfers to dependents or estates and I will discuss this separately). If I have the option and I transfer it to my brother and the company allows it, it would not be treated as an ISO.
7) 7) Annual Dollar Limit: ***For an option to be considered as an ISO, the monetary value of the stock option cannot exceed $100,000 per year***. For example, if the stock is trading at $20 per stock, the maximum stocks that can be granted as an option cannot exceed 5,000 (5,000 x $20 = $100,000). If the value of the option exceeds $100,000, then it would not be treated as an ISO.

Special Rules for 10% or more owners: There are times when an employee already owns10% or more of the company stocks (e.g., a company founder may own 15% of stocks and also is the CEO of the company). Two special rules exist for such cases. Rules 1,2,4, 6,& 7 remain the same whether or not an employee is a 10% or more owner.

However, rules 3 & 5 are modified to be more stringent for employees who own 10% or more stocks in the company. As you recall, rule 3 states that "the option price must not be less than the FMV". For a 10% or more owner-employee, the IRS rule states that "the option price must not be less than 110% of the FMV". For example, if the FMV is $22, then the option price must be 110% of $22 (or $23.20) for the option to be considered as an ISO. The other rule (Rule #5) refers to the duration of the option. For a 10% or more owner-employee, the 10 year duration is reduced to 5 years. That is, the employee must exercise his/her option within 5 years of the option date. For example, if the option is granted on March 26, 2003, the employee must exercise the option on or before March 25, 2008. *Therefore, it is always good to first determine if the employee is a 10% or more owner before deciding which rule to apply!*

Death of the Employee: There are times when the employee may die before exercising the option. When an employee dies, his/her "estate" inherits the rights to exercise the option. Here IRS is more lenient. When an employee dies and the "estate" exercises the options (that is, buys the stocks) the estate can sell the stocks immediately without waiting for the minimum holding periods, etc. The proceeds are treated as estate and the inheritor pays estate taxes rather than income tax or capital gain taxes. Although I am not an expert on Estate Taxes, estate tax laws have a higher exemption limit (half-a-million or more I suppose) than income or capital gain taxes. That is, the estate need not pay any taxes on them. This is perhaps the only situation where the ISOs are transferable.

Non-Qualified Stock Option: Having discussed the ISOs, let us turn our attention to NQSOs. Any stock option that is not an ISO is treated as a NQSO. That is, if all the rules that are set forth for ISOs are met, they are known as ISOs. If any one of the rules set forth for ISOs are violated, then they are known as NQSO.

Taxation of NQSOs and ISOs for the company: As far as the company is concerned, it really does not matter whether a stock option is an ISO or NQSO. The company can write off these

expenses as compensation expenses – salaries, wages, benefits aspect – from their income and expenditure statement.

Taxation of NQSOs and ISOs for the individual: Taxation of stock options for the individuals depend upon whether the option is an ISO or a NQSO.

When the stock option is a NQSO, the option is treated as ordinary income and is taxed at the ordinary income tax rate. Let us take an example: In the year 2003, the company grants an employee 3,000 stocks at an option price of $40 (the value is $120,000 for the year 2003 – $40 multiplied by 3,000. The employee exercises the option in 2004 and sells the 3,000 stocks immediately for a sale price of $50 per stock.

The gain realized by the employee is as follows:

Cost of Stocks: $40 times 3,000	=	$120,000
Revenue: $50 times 3,000	=	$150,000
Gain:	+	$ 30,000.

The gain of $30,000 is treated as ordinary income for the year 2004 because the stock option is a NQSO. The requirements for an ISO are violated because this example did not conform to rules 4 & 7 discussed above.

Currently, the maximum income tax rate on ordinary income is around 39%. Assuming this employee is at the 39% income tax bracket, the employee would pay an income tax of 39% of $30,000.

When the stock option is an ISO, the gain is treated as a capital gains tax and the employee pays capital gains tax.

Let us take an example: In the year 2003, the company grants an employee 3,000 stocks at an option price of $30 (the value is $90,000 for the year 2003 – $30 multiplied by 3,000. The employee exercises the option in 2006 and sells the 3,000 stocks in 2008 for a sale price of $50 per stock.

The gain realized by the employee is as follows:

Cost of Stocks: $30 times 3,000	=	$ 90,000
Revenue: $50 times 3,000	=	$150,000
Gain:	+	$ 60,000.

The gain of $60,000 is treated as capital gains (this option meets all the requirements for an ISOs, you can check this as an exercise). The employee will pay a capital gains tax (around 18% or so) on this gain of $60,000.

In summary, incentive stock options allow the companies to pay the employees in stocks rather than cash. This allows the employees to share in the company's wealth. As the stock price increases, the employees make more money. However, the major drawback of the ISO is the stringent rules and the small dollar amount ($100,000 per year). While this may be good for lower level employees, for large corporations such as Microsoft or GE or GM, this amount will be nothing particularly for top level executives.