WELLS FARGO Advisors

Understanding employer-granted stock options

Important information for option holders

Employee stock options can be a valuable benefit companies provide as part of a benefits package. However, the financial consequences of exercising them can be quite confusing and varied, depending on the features of the options that have been granted.

This report will help explain how stock options are used as compensation and how to differentiate between the types of options. You will also find helpful information about the tax consequences associated with exercising stock options and key terminology.

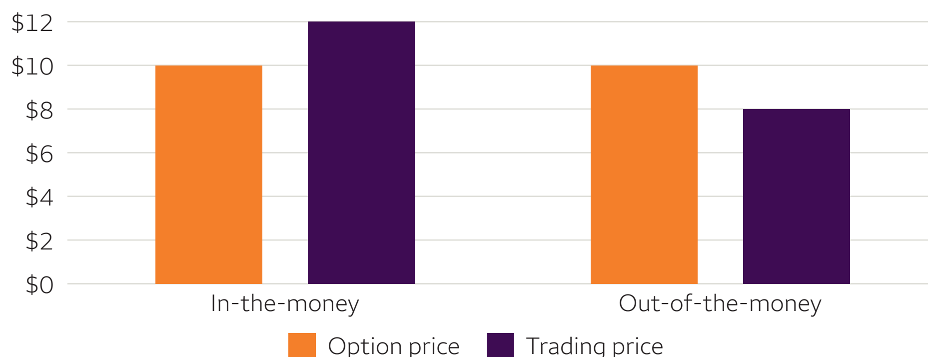
What is a stock option?

An employer-granted stock option is the right to purchase a company's stock in the future at a fixed price. If the company's stock price appreciates, the option's value also appreciates. By offering benefits tied to stock ownership, the company attempts to align an employee's financial goals with those of the company's shareholders.

When you exercise an option, you purchase shares of the company's stock directly from the company. The grant price (also commonly referred to as the exercise price) is the amount you pay to the company for each share. This price is set by the company at the time the stock option grant is made (grant date).

When should you consider exercising your options?

You would consider exercising an option only when it's "in the money." An option is considered to be in-the-money when the employer's current stock price is higher than the grant price. An option is considered "out of the money" (or "underwater") if the current stock price is below the grant price.



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Another factor that may significantly affect the timing of your option exercises is the vesting schedule. Vesting refers to the date on which options can be exercised.

By instituting a vesting schedule, an employer may require you to complete a period of service after the option has been granted before it can be exercised. As a result, vesting schedules help encourage continued employment.

A vesting schedule may be graduated so that some percentage of the options becomes exercisable at regular intervals over a certain period. For example, a common vesting schedule requires that employees wait one year from the grant date before any of the options are exercisable. On the first anniversary of the grant date, 20% of the options can be exercised. Under this type of schedule, the remaining options will continue to vest at the rate of 20% per year for the next four years until all of the options are fully vested.

In contrast, another common cliff-vesting schedule provides that none of the options granted can be exercised within the first three years following the grant date. On the third anniversary of the grant date, all of the options are immediately available for exercise. While time-based vesting remains popular, companies are increasingly granting equity that vests upon meeting certain performance criteria.

Expiration dates refer to the end of an option's life. Stock options are usually granted for a specific period (option term) and must be exercised within that period. A common option term is 10 years, after which, the option expires.

You should be alert to the terms of your stock option plan with respect to any changes in these dates. For example, your company's plan's terms may dictate that if you separate from employment, that separation will accelerate your options' expiration date. It is common for plans to allow as little as 90 days to exercise any remaining options that have vested on or before the event date. These terms may treat different events in different ways. For example, a plan may provide different expiration dates if your separation is the result of termination, retirement, disability, or death.

Types of stock options

Stock options come in two forms: incentive stock options (ISOs) and nonqualified stock options (NSOs). The primary difference between the two types is how you will be taxed.

ISOs

There are no tax consequences to you when you are granted ISOs because no transfer of any property occurs on the grant date. To qualify as an ISO, the options must have a grant price that is not less than the stock price on the grant date and must have an option term of 10 years or less.

When an ISO is exercised, the grant price becomes your cost basis for the shares you receive. When you eventually sell these shares, the difference between the stock's selling price and your cost basis (typically grant price) is the income you must consider for tax purposes. As discussed next, the timing of your sale or transfer of these shares is critical for determining how you will be taxed.

Although there is no taxable event created when you exercise ISOs, there still are potential tax consequences. The difference between the stock price on the exercise date and your option cost represents the taxable spread. If you decide to keep the shares that you receive from an ISO exercise, this taxable spread will become a preference item for alternative minimum tax (AMT) purposes for the calendar year in which the exercise occurs.

Special ISO-related issues

Alternative minimum tax (AMT)
Although exercising an ISO does not result in immediate taxation, the taxable spread is a preference item for the AMT. If you hold the ISO shares beyond December 31 of the year in which the option exercise occurs, this preference item will be included as part of your AMT calculation for each share that you continue to hold. If you sell the shares in the next calendar year, but before meeting the holding requirements, you can create a scenario in which the same taxable spread results in AMT liability in the year of exercise and ordinary income in the next year.

If you have large ISO grants, plan carefully so you can avoid stacking up too many options to be exercised in any one year. Consult your tax advisor to determine whether and how the AMT may affect you and to help you plan ISO exercises. Careful planning may help limit your AMT exposure.

$100,000 rule
Vesting schedules are particularly relevant with respect to ISO grants. When a company grants ISOs, the combined value of all shares that can be exercised for the first time (i.e., vested) in any one calendar year cannot exceed $100,000. The value is measured by the stock's value on the grant date. If the value of the vesting shares exceeds $100,000, the excess portion will be denied ISO treatment and will be taxed similarly to NSOs.

When you sell stock received from ISO exercises, the timing of that sale becomes critical. As long as you have held the stock for the required holding period—at least one year from the exercise date and two years from the grant date—the entire difference between the stock's selling price and your cost basis will be taxed as a long-term capital gain. The greater the difference between the long-term capital gains tax rate and your marginal tax rate, the more attractive an ISO becomes.

If you don't retain the stock for the required holding period (as defined above), you will not qualify for long-term capital gains tax treatment. This is referred to as a "disqualifying disposition."

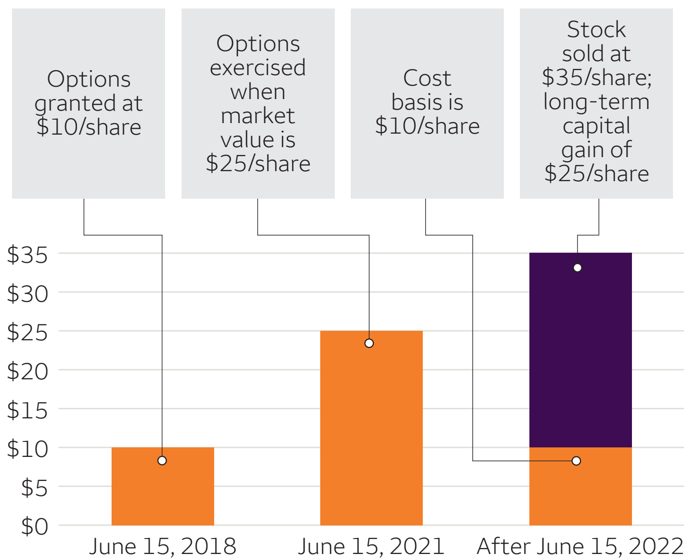
If you "disqualify" your ISO shares, you will be taxed in a similar manner as with NSOs, discussed next. The taxable spread created upon the exercise of the options (stock price minus the grant price) will be taxed as ordinary income based on marginal tax rates. If the stock has appreciated since the exercise date, that appreciation will be taxed as a short-term capital gain. The chart on the following page contains a side-by-side comparison detailing the difference in tax treatment for ISOs that satisfy the holding period and those that are sold in a disqualifying disposition.

Typical tax treatment of an ISO[1] that has met the required holding period

Grant date:	June 15, 2018
Number of options:	1,000
Grant price:	$10
Stock price at exercise:	$25

At exercise (June 15, 2021)	
Payment to company:	1,000 x $10 = $10,000
Shares to optionee:	1,000
Cost basis:	$10 per share
Taxable spread:	($25 - $10) = $15[2]

Upon sale of shares occurring on or **after** June 16, 2022	
Selling price:	$35
Cost basis:	$10
Long-term capital gain:	$25[3]

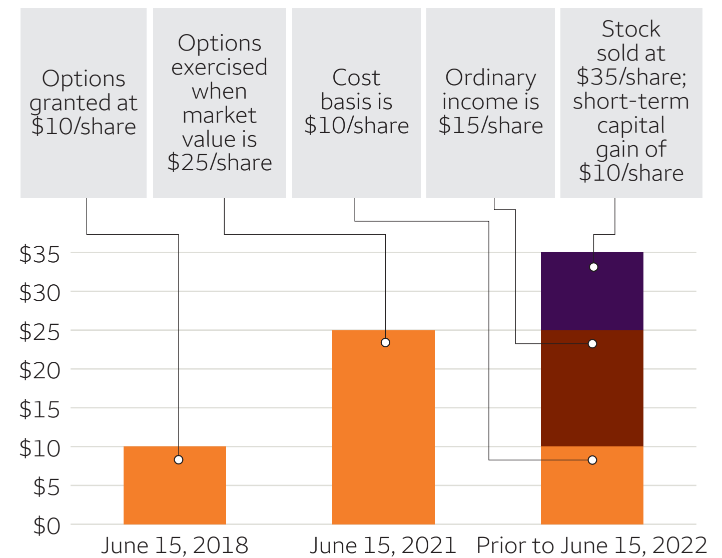


Typical tax treatment of the same ISO[1] in a disqualifying disposition

Grant date:	June 15, 2018
Number of options:	1,000
Grant price:	$10
Stock price at exercise:	$25

At exercise (June 15, 2021)	
Payment to company:	1,000 x $10 = $10,000
Shares to optionee:	1,000
Cost basis:	$10 per share
Taxable spread:	($25 - $10) = $15[2]

Upon sale of shares occurring on or **before** June 15, 2022	
Selling price:	$35
Cost basis:	$25[4]
Ordinary income:	$15 per share
Short-term capital gain:	$10[5]



Another important feature associated with ISOs is the necessity of an ongoing relationship with the employer. If you have been granted ISOs and your employment is terminated, your ISOs will qualify for long-term capital gains tax treatment for 90 days following your separation date. After 90 days, your ISOs may expire, or they may be converted to NSO tax treatment. Therefore, you should carefully review the terms in your option agreement and stock plan to determine how the options will be treated if you are terminated, voluntarily separate, retire, become disabled, or die.

1. These hypothetical examples are designed to illustrate the effects of certain planning strategies based on stated assumptions. The strategies described may or may not be suitable for your particular situation. Before implementing any strategy, you should seek the advice of your tax and legal advisors. No guarantee of specific results is made.
2. AMT preference item (per share)
3. Because this sale occurred more than two years after the options were granted and one year and one day after the options were exercised, the holding period requirement was met. Therefore, this transaction qualified for long-term capital gains treatment.
4. Because both tests for meeting the holding period requirement have not been met, the ISO status is disqualified. When you sell, the stock price at exercise ($25) becomes the cost basis because you are obligated to pay ordinary income tax based on the taxable spread on the date of exercise ($15) and you have paid the grant price ($10).
5. Because you have not held the shares for at least one year and one day following exercise, the capital gain is a short-term capital gain, currently taxed at marginal tax rates.

NSOs

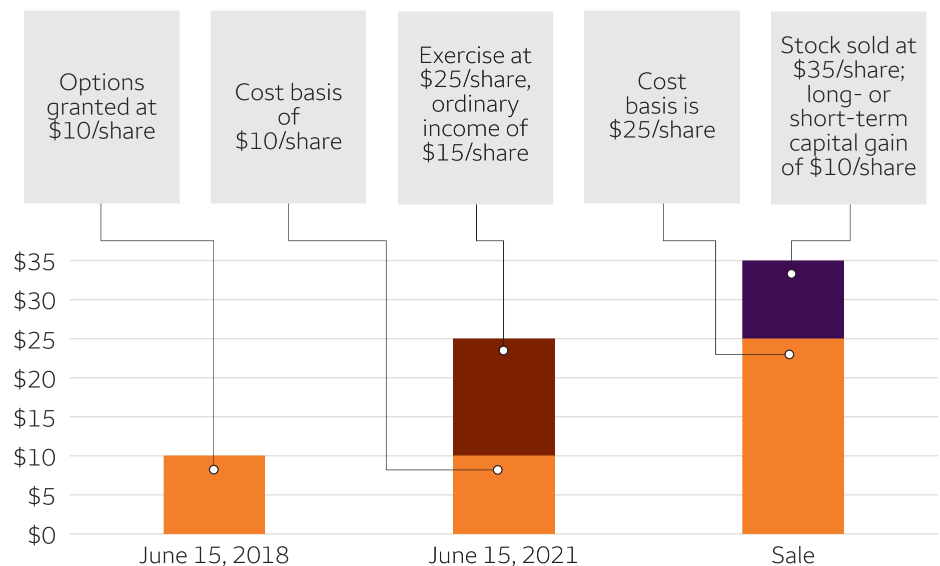
NSOs are the more common type of options companies grant. As with ISOs, no taxable event is created when NSOs are granted. Unlike ISOs, a taxable event occurs when you exercise NSOs. This taxation occurs whether you sell the resulting shares immediately or continue to hold them following exercise.

When an NSO is exercised, you must recognize ordinary income equal to the taxable spread (stock price on the date of exercise minus the grant price). This income will be considered compensation income paid to you and will be included on your Form W-2. This compensation will be subject to income taxes, as well as payroll taxes.* (See “Planning for Withholding Taxes” on page 6.) Once NSOs are exercised, your cost basis for the shares will be equal to the stock price on the exercise date. If you elect to hold the shares following exercise, this cost basis will be critical to computing your future gains or losses when you eventually dispose of the stock.

When you sell the shares, you will recognize a capital gain or loss equal to the difference between your cost basis (stock price at exercise) and the price at which you dispose of the shares. If you sell within one year of the exercise date, the capital gain or loss will be short-term. If you sell the shares more than one year after the exercise date, a long-term capital gain or loss will result.

Using the same facts as our ISO example on page 4 (1,000 options, $10 grant price, $25 stock price on the date of exercise), when you exercise your NSOs, you would recognize $15 per share as ordinary income ($15,000 total). Depending upon how long you hold the shares following exercise, you would recognize a short-term or long-term capital gain on any selling price in excess of $25 per share (your cost basis).

Typical NSO† tax treatment



*FICA (up to the FICA wage base) and Medicare

† This hypothetical example is designed to illustrate the effects of certain planning strategies based on stated assumptions. The strategy described may or may not be suitable for your particular situation. Before implementing any strategy, you should seek the advice of your tax and legal advisors. No guarantee of specific results is made.

Funding your stock option exercise

The cashless stock option exercise funding strategy generally applies to publicly traded companies where there is an available market on a stock market exchange. You should consult with your employer for private company exercise alternatives.

The simplest way for you to exercise your option is a cash exercise; i.e., you simply write a check to the company for the purchase amount (grant price times the number of options being exercised) in addition to any applicable taxes. However, raising the cash to pay this purchase price can be difficult.

If you don't have available cash to fund your option exercises or don't want to use your cash reserves to exercise your options, there are other strategies that may be available, depending upon your situation.

'Cashless' stock option exercises are very popular. A cashless stock option exercise lets you exercise your options without raising large amounts of cash or disturbing your existing portfolio or cash reserves.

Using a cashless stock option exercise, you can either sell all of the shares immediately or hold a portion for potential future appreciation. Once you have determined how many shares you want to sell, your Financial Advisor will place a trade to sell your shares in the open market even before the shares are delivered by your company. When the order executes, Wells Fargo Advisors advances the necessary funds to pay the exercise costs and any tax withholdings the company requires. We then work with your company to ensure that the shares are delivered to Wells Fargo Advisors and the net shares or net proceeds will be available to you.

Contact your Financial Advisor, who can help you take advantage of Wells Fargo Advisors' Cashless Stock Option Exercise program. He or she will notify your company of your intent to exercise through Wells Fargo Advisors and verify that your options are available and ready to be exercised.

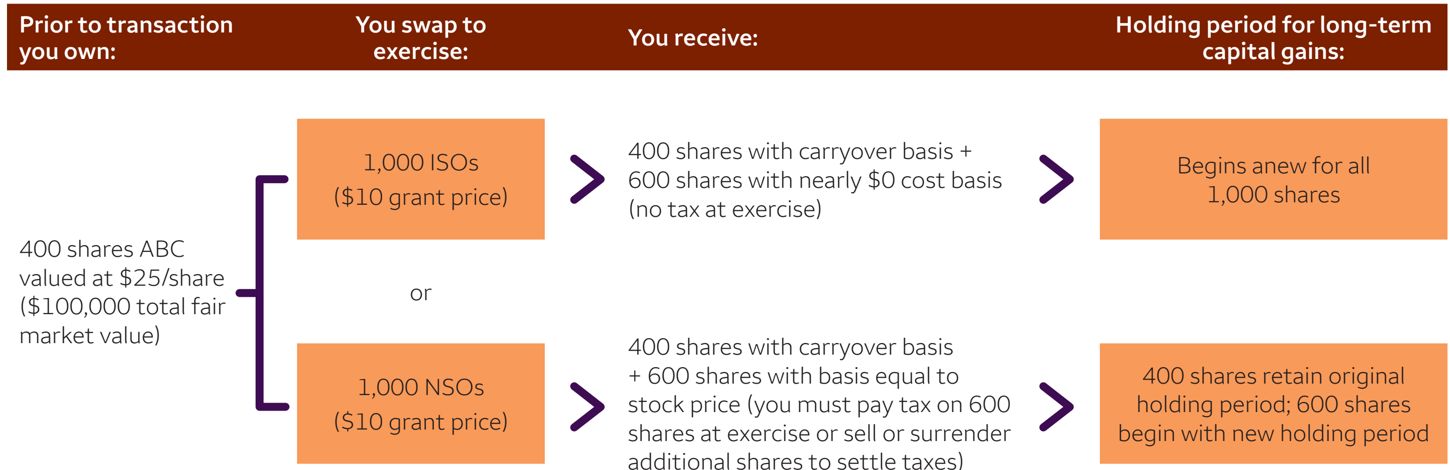
Planning for withholding taxes

Your employer will report the ordinary income you must recognize in the year you exercise your NSOs on your Form W-2. As with any other compensation, your employer will generally withhold federal income tax (at the same rate as the taxation on bonus compensation — currently 22%), employment taxes (Social Security and Medicare, which could be as high as 8.55% depending on other compensation paid to you), and any other applicable state or local income tax. Most employers require you to remit any required tax withholding along with the amount you pay to exercise your option. Because this increases the cash you need, you should factor withholding taxes into your cash planning. Be sure to consult your tax advisor before exercising stock options to determine the additional taxes you may owe.

A common variation of cashless stock option exercise is a strategy known as "sell to cover." Using this strategy, your Financial Advisor will sell only those shares necessary to fund the exercise costs and taxes associated with exercising the amount of options you want to exercise. You continue to hold the option shares in excess of those needed to pay the costs of the entire exercise. As a result, the exercise is self-funded.

A stock swap is another funding method. If your employer's stock option plan contains a stock swap feature and you already own company stock, you may be allowed to trade your existing shares back to the company to pay the grant price for exercisable options. The stock price of the shares you surrender will determine how many options you can exercise. See the example below.

Tax consequences of a stock swap



Prior to transaction you own:	You swap to exercise:	You receive:	Holding period for long-term capital gains:
400 shares ABC valued at $25/share ($100,000 total fair market value)	1,000 ISOs ($10 grant price)	400 shares with carryover basis + 600 shares with nearly $0 cost basis (no tax at exercise)	Begins anew for all 1,000 shares
	or		
	1,000 NSOs ($10 grant price)	400 shares with carryover basis + 600 shares with basis equal to stock price (you must pay tax on 600 shares at exercise or sell or surrender additional shares to settle taxes)	400 shares retain original holding period; 600 shares begin with new holding period

In general, it is better to perform a stock swap with ISOs because of the tax treatment afforded to you if you are able to hold the shares for more than one year following the swap. The advantage of a stock swap is that you avoid paying capital gains tax on the shares you surrender. But you also need to realize that by swapping existing shares for option shares you will end up with fewer shares than if you simply purchase the options outright.

In the example provided, you are swapping shares to exercise ISOs and your holding period will begin anew on all 1,000 shares. Any disposition prior to this date will result in a disqualifying disposition (for ISO shares). If you are swapping shares in an NSO exercise, the shares have different holding periods. Some of the shares will have a carryover holding period and others will have a holding period that commences after the swap. If you fail to meet the holding period requirements, selling the shares will result in short-term capital gains tax treatment.

The tax and company policy consequences of a stock swap can be complex. If you're considering the stock swap strategy, you should consult with your tax-advisor, as well as your company's benefits consultant or counsel to ensure compliance with company policies, which vary.

Margin loans may also be available to fund your option exercises. Using this strategy, you borrow the necessary funds from Wells Fargo Advisors to cover the exercise costs and taxes associated with your investments. The shares received from the option exercise are then deposited into your Wells Fargo Advisors account and serve as collateral for the outstanding loan until it is repaid. The amount you can borrow is subject to regulation and is tied to the value of your holdings in the account. Because of the risk, this should not be considered as a long-term strategy and may not be suitable for all investors. In addition, you must check your company trading policy to make sure a margin loan is allowed.

Taxation and cost basis of stock options and SARs

	Taxation	Purchase date for tax purposes	Cost basis per share
Stock options			
NSO	Ordinary income tax on gain	Exercise date	Fair market value at exercise
ISO	N/A (AMT preference item)		Exercise price Disqualifying disposition: Exercise price + ordinary income
Stock Appreciation Rights			
Stock-Settled SARs	Ordinary income tax on gain	Exercise date	Exercise date
Cash-Settled SARs	Ordinary income tax on gain	NA	NA

Understanding Stock Appreciation Rights (SARs)

SARs give you the ability to request the appreciation in the value of a stock from the date of grant to the date you choose to exercise your SARs. This value is equal to the spread between the SAR's grant price and the issuer's stock price on the date of exercise.

The proceeds from SAR exercises can be paid in cash or stock. The value (appreciation) created at exercise will be included as ordinary taxable income on your W-2 and the taxes must be paid before the exercise is settled in cash or net shares. If the SARs are stock-settled, the stock price on the date of exercise becomes the cost basis of the net shares received.

As with any other compensation, your employer will generally withhold federal income tax, employment taxes (Social Security and Medicare), and any other applicable state or local income tax.

The strategies you would employ with a SAR are much like the strategies you would consider with an employer granted stock option. You would only consider exercising a SAR when it's "in-the-money," which means the issuer's current stock price is greater than the grant price of the SAR. Like an employer granted stock option, SARs have a grant price, vesting schedule and expiration date.

Unlike an employer granted stock option, you need no up-front cash to exercise your SARs. You will receive the appreciated value of the SAR above the grant price at the time of exercise. To exercise your SAR, you will need to notify your company of your desire to exercise in accordance with the process outlined in your stock plan or agreement. Because no shares need to be sold into the market to exercise SARs, there is less dilution to the company's shareholders. For this reason, SARs may continue to be a preferred equity benefit by companies.

Making the most of your stock option benefit

Because of the varying cash requirements and tax consequences associated with ISOs and NSOs, carefully consider when you should exercise your options and develop an option exercise strategy that works for you. You should include your Financial Advisor with your team of legal and tax advisors to develop an exercise strategy that furthers your overall financial plan.

Combine your knowledge of your company, your Financial Advisor's knowledge of the market conditions, and any other factors that can affect your stock's trading patterns. Factor in your tax advisor's evaluation of your tax situation and how exercising your options will affect your current and future tax liabilities. Once you've assessed these relevant factors, you can begin to meet your goals with a well-planned exercise and/or sales strategy.

Glossary

Alternative minimum tax (AMT): A special tax originally designed to help ensure that wealthy individuals couldn't use certain strategies to avoid paying income taxes. Today, more taxpayers find themselves subject to the AMT. Exercising ISOs can generate an AMT preference item equal to the difference between the option price and the stock's value on the exercise date.

Capital gain or loss: The difference between an employee's cost basis and the stock's market value on the day a security is sold. Capital gains (or losses) are short-term if the employee holds the security for one year or less and long-term if he or she holds the security for more than one year.

Cashless option exercise: A method of exercising stock options without requiring the employee to make any initial cash outlay.

Commission: The fee a financial institution charges for executing a transaction.

Cost basis: For NSOs, the stock's value on the exercise date. For ISOs, the grant price paid when options are exercised (unless disqualified).

Disqualifying disposition: The sale or other disposition of shares acquired through an ISO exercise before satisfying the holding requirement.

Exercise date: The date stock options are exercised to purchase stock at the grant price.

Exercise price: See "Grant Price."

Grant date: The date stock options are given to the recipient.

Grant price: The price an employee must pay the company for shares purchased when exercising options. The grant price is set on the grant date. Also referred to as the option price, exercise price or strike price.

Incentive stock option (ISO): A type of stock option that qualifies for special tax treatment. Exercising an ISO does not create taxable income; however, it may increase the possibility that the employee will be subject to the AMT.

In-the-money: A phrase used to describe the value of stock options whenever the market price of the underlying stock rises above the grant price.

You can count on us

Your Financial Advisor will work with you and your tax advisor to create an exercise strategy for your employer-granted stock options.

Margin loan: A loan that lets an individual purchase stock and borrow up to half its market value from a brokerage firm. Using this strategy comes with substantial risk and may not be allowed by the employer.

Market price or value: The current stock price of a public company as determined by the stock market.

Nonqualified stock option (NSO): A type of stock option that incurs ordinary income taxes at exercise, regardless of whether the shares are sold or held.

Option price: See "Grant Price."

Out-of-the-money: A phrase used to describe the value of stock options whenever the market price of the underlying stock is below the grant price.

Settlement date: The date by which either cash (for a buyer) or shares of stock (for a seller) must be delivered to a brokerage firm to complete a securities transaction.

Spread: The difference between the grant price and the stock's value on the exercise date.

Stock option: A right a company issues that gives the recipient the ability to purchase a specific number of shares of company stock at a specified price during a specific period.

Stock option agreement: A document that sets forth the terms of options issued to employees. It includes the type and number of options granted, vesting schedule, expiration date, and funding alternatives.

Stock option financing: See "Cashless Option Exercise."

Stock swap: A feature that lets an option holder surrender shares of company stock he or she owns to cover the amount owed on the exercise date.

Strike price: See "Grant Price."

Stock symbol: The unique identification symbol given to a corporation whose stock is traded on a stock exchange.

Underwater options: See "Out of the Money."

Vesting: A schedule requiring that a certain time period elapse after the option is granted before it can be exercised.

Talk to Wells Fargo Advisors

We welcome the opportunity to work with you to help you achieve your financial goals. Let us know if there are any other topics or services of interest to you.

Margin borrowing may not be suitable for all investors. When you use margin, you are subject to a high degree of risk. Market conditions can magnify any potential for loss. The value of securities you hold in your account, which will fluctuate, must be maintained above a minimum value in order for the loan to remain in good standing. If it is not, you will be required to deposit additional securities and/or cash in the account or securities in the account may be sold. Clients are not entitled to choose which securities in their accounts are sold. The sale of their pledged securities may cause clients to suffer tax consequences. Clients should discuss the tax implications of pledging securities as collateral with their tax advisors. An increase in interest rates will affect the overall cost of borrowing. Wells Fargo Advisors and its affiliates are not tax or legal advisors. Margin strategies are not suitable for retirement accounts. Please carefully review the margin agreement, which explains the terms and conditions of the margin account, including how the loan is calculated.

This publication is designed to provide accurate and authoritative information regarding the subject matter covered. It is made available with the understanding that Wells Fargo Advisors is not engaged in rendering legal, accounting or tax-preparation services. If tax or legal advice is required, the services of a competent professional should be sought.

Wells Fargo Advisors' view is that investment decisions should be based on investment merit, not solely on tax considerations. However, the effects of taxes are a critical factor in achieving a desired after-tax return on your investment.

The information provided is based on internal and external sources that are considered reliable; however, the accuracy of the information is not guaranteed.

Specific questions on taxes as they relate to your situation should be directed to your tax advisor.

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