



Investment Spotlight

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Employee Stock Option Basics

Stock option programs have gained so much in popularity that today, more than 5.5 million individuals are on the receiving end of stock options, hoping to cash in their new asset for big bucks.

If you are one of the lucky ones, then you know that one of the biggest challenges for any option-holder is deciding when to exercise the option and sell the stock for the greatest gain and smallest tax hit. Taxes due on an exercise and stock sale may be considerable and will vary according to the type of option exercised, as well as the timing of the exercise. One of the first things you will need to do is familiarize yourself with the type of stock option grants you hold.

Let's start with some of the basics. An employee stock option is the right to purchase company stock at a specific price—the exercise or strike price—within a specified time period. The exercise price is typically the market value of the stock at the time of the grant. The time frame for exercise varies between company plans, but typically begins one year after the grant for a percentage of the grant. An additional portion will vest each year, until all are vested and can be exercised.

For example, an employee receiving 100 stock option grants in July, when the market value of the stock is \$64, will be able to exercise the first portion (or in this case, 20 percent) of that grant the following July, at a \$64 exercise price. An additional 20 percent will vest each year until all options are vested at year six. The options expire ten years from grant, after which they can no longer be exercised.

	Spread on Exercise	Stock Appreciation
Incentive Stock Options	Capital Gain Alternative Minimum Tax	Capital Gain
Disqualifying disposition of Incentive Stock Options (early stock sale)	Taxable compensation, taxes paid with income tax return	Taxable compensation, taxes paid with income tax return
Nonqualified Stock Options	Taxable compensation with payroll tax withholdings	Capital Gain

If the employee chooses to exercise all 100 options at year six, the exercise price will be \$64, and the earnings will be derived from the "spread," or difference between the exercise price and current market value of the stock. In this case, let's say the stock has increased to \$85 per share in the six years since the option grant. The earnings will be \$85, minus the \$64 grant price, leaving \$21 per share, or \$2,100 in option exercise earnings. The individual, however, must now pay taxes and transaction fees on these earnings.

Incentive vs. Nonqualified Stock Options

The two types of stock options are incentive stock options and nonqualified stock options. The difference between these lies in their tax treatment. Nonqualified stock options are taxed as compensation at the time of exercise through payroll withholdings taken on the spread between the exercise price and market value at the time of exercise. Any subsequent appreciation of the stock is taxed as a capital gain.

Incentive stock options, on the other hand, receive preferential tax treatment with option earnings and stock appreciation taxed at the lower capital gains rate. If you are a candidate for the Alternative Minimum Tax, you will need to include the spread at exercise in your calculations. Capital gains tax is eliminated, however, when the stock is not held for the required holding period of two years from the grant and one year from exercise. Breaching the holding period is termed a disqualifying disposition, and results in the conversion of both the option earnings and stock appreciation to taxable compensation, which you must report on your tax return and pay the associated federal and state income tax.

The chart illustrates the various tax applications for stock option grants. Remember: You should take the time to learn as much as you can about stock options, so that any decision you make is informed and also includes your personal circumstance and financial needs. Consult your personal attorney, accountant or other qualified tax advisor for guidance. **P&SF**