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Employee Stock Options: 4 Things You Must Know Before You Say 'Yes'

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Many companies entice new employees -- and current ones -- with these offers. Here's what you need to know...

Humans are generally not very good at restraining themselves, which is why they invented handcuffs.

You could make a solid argument that wedding rings count as handcuffs, but even if you disagree with that notion, there's no disputing that handcuffs come in a variety of shapes, sizes and materials.

Not all handcuffs are metal, though. If your company has granted you stock options as part of your compensation package, you're looking at another kind of handcuff -- a financial one intended to keep you chained to your employer as long as possible.

Before you resist arrest, here are a few terms to know.

#-ad_banner-#**Stock Option**

When an employer gives you stock options, it's giving you the right, but not the obligation, to buy shares of the company at a specified price (the strike price) on or before the option's expiration date (usually several years from now). The value of your options is derived from the price of your employer's stock.

Let's say you work for Company XYZ, and the company grants you options to buy 1,000 shares for $40 a share in the next 10 years. This sounds awesome, but remember two things:

- You can't buy groceries with stock options.
- Those stock options are only valuable if the stock is trading above $40 per share before the options expire.

For instance, if Company XYZ shares rise to $60 and you have the right to buy shares for $40, you could exercise your options, pay $40,000 for your shares ($40 x 1,000) and turn right around and sell them in the open market for $60,000. You'd make $20,000 of easy money.

Usually, companies grant options with strike prices above the current market price. In our

example, the company might give you options at $40 a share even though the stock is only trading at $30 a share right now. That makes your options worthless, because you wouldn't pay $40 for a $30 stock.

Therein lies the rub. If you're the head of marketing for Company XYZ, you have some influence over how well the company does. If you want to make money on your stock options, naturally you'll start thinking about what you can do to make the company worth more so the stock price goes up.

That's the beauty of option grants. By giving you skin in the game, they get you invested in the cause: increasing shareholder value.

Option Grants

Receiving your options is called getting an option grant. Company XYZ is the grantor, and you are the grantee. The board of directors of Company XYZ has to approve the number of shares that management doles out in option grants, and often boards dictate the terms of the grants to employees in certain roles (e.g., all the vice presidents get 1,000-share grants, all the director-level employees yet 750-share grants, etc.).

Options grants often have to vest, meaning a portion becomes exercisable over time. So, if last year Company XYZ granted you 1,000 options at $40 but the options vest 20% per year over five years, then only 20% of your 1,000 shares is exercisable right now. Next year, 40% of your 1,000 shares will be exercisable; the year after that it's 60%. If the stock price tops $40 during that time, you can exercise your options, but only the ones that are vested. This tantalizing handcuff gets you to stick with the company longer.

Often, a change in control accelerates vesting. So, if ABC Company acquires Company XYZ next year, 100% of your 1,000 options will likely become immediately exercisable.

Nonqualified Options (NQOs) and Incentive Stock Options (ISOs)

There are two primary kinds of employee stock options: nonqualified options (NQOs) and incentive stock options (ISOs).

If you get NQOs, you pay ordinary income tax on the difference between the exercise price and the market value of the stock when you exercise. So, let's say that three years after your 1,000-option grant, Company XYZ stock is up to $60. You decide to exercise even though only 600 of your options are vested.

You think the stock is going to continue to increase, so you hold onto the shares. Even though you haven't sold the shares, you have to pay ordinary income tax on the difference between the exercise price and the market value at the time of exercise. In our example, that difference would be 600 shares x ($60 - $40) = $12,000. If you're in the 28% tax bracket, that means you'll pay $3,360 even though you haven't sold the shares yet. And watch out—you'll pay capital gains tax if you eventually sell the shares for more than $60.

If you get ISOs, you generally don't pay taxes when you exercise; instead, you pay capital gains tax on the difference between the exercise price and the price at which you eventually sell your stock. So, let's say that three years after your 1,000-option grant, Company XYZ stock is up to $60. You decide to exercise even though only 600 of your options are vested. If you sell the

shares immediately, you make a profit of 600 x ($60 - $40) = $12,000. But, you pay short-term capital gains tax on that profit, which is, say, 35%, or $4,200.

On the other hand, if you exercise and then hold onto the stock for, say, five years before selling them at $60, you still make a $12,000 profit, but now you pay long-term capital gains tax, which is, say, 15%, making your tax bill $1,800.

The Investing Answer: Employee stock options are a way to handcuff you to a company. It can be a sweet imprisonment, however. If your company does well and the stock goes up, the amount of money you can make is limited only by the strike price, the stock price, the tax code, and your patience.

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