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How to Maximize Your Employee Stock Options

by Andrew Salak, Senior Consultant

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Is your role changing or were you recently promoted? Are stock options part of your new compensation package? If you answered 'yes,' this is no surprise. More and more companies are granting employee stock options (ESOs) to rank and file employees within compensation packages. ESOs can be a useful tool to attract, retain and motivate employees by aligning employee compensation with company growth. ESOs can also be a lucrative way for employees to grow wealth over time, however, they can be complex and difficult to understand. Familiarizing yourself with the basic concepts and terminology associated with ESOs is a good starting point.

While each stock option plan has its own rules, they all involve the transfer of an equity interest in a company to an employee in the form of compensation. In some cases, the employee is granted the right to purchase the equity interest. In others, they are simply given the shares upon meeting plan requirements, generally based on length of service.

Key Terms

Grant Date – The date when the employer awards the stock options to the employee.

Grant Price – The price of the underlying security on the date the option is granted. This value determines the cost of compensation to the employer for certain types of options.

Strike Price – The fixed price the employee can buy the stock at on a later date.

Vesting Schedule – The time frame which specifies when options within the grant are eligible to be exercised. Generally, most plans require a waiting period of at least one year before options may be exercised.

Exercise Date – The date the employee purchases the company stock at the grant price.

Expiration Date – The last date on which the options can be exercised. This is a key date to know, as the stock options become worthless after their expiration date. It also is important to understand that most options expire upon termination of service, or shortly thereafter.

Most Common Types of Employee Stock Options

Restricted Stock Units (RSUs) – The employee is granted shares that vest over time, similar to a bonus. The employee is not required to purchase the shares, as they are given based on achievement of time or performance requirements. When the shares are issued, the employee is responsible for paying income tax on the value of the shares received on the date the shares are vested. The employee can sell a portion of the shares to cover the tax liability and retain the other shares for future sale. If the employee holds the shares for at least a year after receipt, any growth of the shares is taxed as long-term capital gains when sold.

Non-qualified Stock Options (NQSOs) – The employee is granted the right to purchase shares at a specified price (strike price) based on the vesting schedule. Upon exercising this right, the employee must tender funds to pay for the shares at the strike price If the price of the stock is higher than the strike price, the employee is responsible for paying ordinary income tax on the difference between the market value and strike price, regardless of whether they retain the shares. If the employee retains the shares for at least one year from the date of exercise, any appreciation above the market value on the exercise date would be taxed as long-term capital gains.

Incentive Stock Options (ISOs) – Similar in structure to NQSOs, ISOs are reserved for employees only, and typically used to retain key managers and/or executives. ISOs have a special tax advantage that makes them very attractive for key employees. As with NQSOs, the employee is required to tender funds to cover the strike price upon exercise. However, if the market value of the stock on the exercise date is higher than the strike price, that differential may not be subject to tax due to ISO's special tax treatment. If shares are held for at least one year after the exercise date and two years after the grant date, gains can be taxed at long-term capital gains rates. Depending on individual circumstances, the exercise of an ISO may trigger AMT liability which could be payable prior to the determination of special tax treatment. All ISOs are subject to a mandatory expiration after ten years. Since the exercise of ISOs involves complex tax rules, it is advisable that employees discuss tax repercussions with their tax professional before, during and after the exercise of the option.

Key Considerations

One of the key considerations when accumulating stock is the risk of owning too many shares of one single company. Recipients of ESO's should consider their shares in company stock as one piece of their overall investment strategy and recognize that owning individual stocks can be more volatile than a diversified portfolio. Additionally, owning stock issued by one's employer could create a dual risk if the business is facing financial hardship. In this scenario, the recipient's share price could be falling while their job may be at risk.

When evaluating compensation packages, it is important to assess all benefits presented. While ESOs can provide a compensation enhancement, employees should weigh the features of the program, the outlook for the organization and individual long-term plans. Navigating these details entails thoughtful planning and potentially guidance from a financial and/or tax professional. For more information on maximizing employee stock options, please reach out to one of the Consultants in The Wealth Office® at Fiducient Advisors.

About the Author

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Andrew provides investment consulting services to nonprofit organizations, municipalities, corporate executives, family trusts and other private investors. He supports clients by providing advice and expertise on asset allocation, portfolio design, investment policy statements, manager search process and overall investment management. He also guides clients through a comprehensive wealth planning process to ensure coordination of investment objectives with their financial planning, estate planning, tax and lending strategies. Andrew joined Fiduciary Investment Advisors LLC in 2014, which combined with Fiducient Advisors in 2020.

Prior to joining the firm, he was a Financial Advisor at Morgan Stanley providing financial planning services to high-net-worth individuals. He holds a BA from Fordham University in New York City. Andrew was selected by the Hartford Business Journal in their 40 Under 40 class for 2018. He is the President of the Fordham Alumni Association of Connecticut and a Past President of the Hartford Tennis Club. Additionally, he volunteers as a member of the Professional Advisory Committee for the Hartford Foundation for Public Giving. In his free time, Andrew enjoys playing tennis competitively, golf, traveling and volunteering.