SEVEN FACTS EVERY EXECUTIVE SHOULD KNOW ABOUT STOCK OPTIONS

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If you are like many executives we know, you never quite have the time to manage your various stock grants, no matter how hard you have worked to earn an attractive level of stock-based compensation.

You may even know there is a downside to postponing the day of reckoning that can take the form of a loss of your hard-earned income as well as possible tax liabilities. Even then, assembling your grant paperwork and making decisions on your grant dispositions can still seem too daunting.

Unlocking the complex potential in your stock-based compensation can be made easier when you consider these seven facts about stock options.

Executive Financial Coach and Financial Advisor, Charles "Chuck" Steege, CFP®, is President of SFG Wealth Planning Services, Inc./SFG Investment Advisors, Inc. (SFG), a fee-only financial planning firm and SEC Registered Investment Advisor. SFG is dedicated to assisting senior executives and their employees with their complex stock-based compensation and planning challenges.

YOUR COMPANY STOCK PLAN IS AN IMPORTANT SOURCE OF FUTURE WEALTH

FACT 1: A STOCK OPTION ALLOWS YOU TO TAKE POSSESSION OF A FIXED NUMBER OF YOUR COMPANY'S STOCK SHARES

Restricted stock is an insider holding with sales restrictions and must be traded in compliance with special SEC regulations. Stock option grants last 10 years. During that time, you may choose whether to hold each option until it expires or "exercise" an option by purchasing the underlying stock.

FACT 2: YOU WILL BE FACED WITH ONE OF TWO DIFFERENT TYPES OF STOCK OPTIONS, NON-QUALIFIED STOCK OPTIONS (NQOS) OR INCENTIVE STOCK OPTIONS (ISOS), WHICH EACH REQUIRE DIFFERENT STRATEGIES

While the cost to buy an NQO or an ISO is the same, that's where the similarity ends. Major differences in how each is treated from a tax perspective can have a major impact on how you maximize the value of your stock award.

	Non-qualified stock option (NQO)	**Incentive stock option (ISO)**
Let's do the math I	Let's say ABC Corporation granted you an option for 2000 shares of stock at $50 a share ($100,000 in total). Seven years later, you have elected to exercise the option when the shares appreciated to $100 a share ($200,000 in total), and you are ahead or "in the money" by $100,000.	
Description	NQOs are non-qualified stock options because they don't meet all of the requirements of the Internal Revenue Code to be qualified as ISOs. NQOs are simpler and more common than ISOs.	This type of employee stock option has a tax benefit: When you exercise it, rather than paying ordinary income tax, the options are instead taxed at the capital gains rate, if shares are held for a year and a day.
Tax considerations	With this type of employee stock option, you pay ordinary income tax on the difference between the grant price and the price at which you exercise the option. Once exercised, any amount above the exercise or "sell" price would be immediately included as ordinary income in a W2 form. The exercise of an NQO option, if sizeable enough, can also push an individual into a higher tax bracket.	By observing the holding period requirement, you can convert from an Alternative Minimum Tax (AMT) rate of 28% to a 15% capital gain tax rate. While ISOs have more favorable tax treatment than NQOs, they also require the holder to take on a bit more risk if the individual elects to hold the shares of stock for a longer period of time in order to receive the more favorable tax treatment.
Let's do the math II	If you are in the 35% tax bracket, you would pay up to $35,000 as ordinary income.	If you are in the 35% tax bracket, and observe the favorable terms of the year-and-a-day holding period, you would pay up to $15,000 at the maximum capital gains rate.

IN SOME FIRMS, EXECUTIVES MAY CHOOSE WHICH STOCK PLAN THEY PREFER; AND, IN A FEW CASES, EXECUTIVES MAY CHOOSE BOTH.

OVERLOOKING TAX-ADVANTAGED EVENTS IS LIKE LEAVING YOUR MONEY ON THE TABLE

FACT 3: TO FULLY REALIZE THE BENEFIT OF EACH GRANT TAKES A COMPLEX BLEND OF TIMING, TAX AWARENESS AND CLEARLY ARTICULATED FINANCIAL OBJECTIVES

The IRS views your stock option as a kind of non-interest bearing loan. Eventually, you will pay for that "loan" at the appropriate tax rate. For our example, we've been citing the maximum bracket for NQOs at 35%. In effect, the shares act as a growing loan balance to the U.S. government.

When is it right to continue holding on to your NQO? As long as you hold onto the options, there are no tax consequences. However, holding onto the options during periods of sudden volatility can leave you a lot less money down the road.

You could exercise an NQO earlier and pay the taxes. Decisions about exercising an NQO depend upon what you believe is going to happen to the stock price. Ultimately, selling your shares depends on your near-term and longer-term financial objectives.

With an NQO you pay the taxes up front out of the proceeds from the non-qualified shares that become available when they are sold. Unlike an ISO, it is immaterial from a tax year perspective when you exercise a NQO.

FACT 4: TO TAKE ADVANTAGE OF THE 15% RATE AVAILABLE THROUGH ISOs REQUIRES FORESIGHT AND PLANNING

In effect, because you receive a kind of credit for paying your Alternative Minimum Tax, it is imperative to document carefully all AMT reporting, as well as tracking the credit for each grant. It's the amount due, or credited, back to you that will lower your tax liability to 15%.

With ISOs, it might be better to exercise the options earlier in the year rather than later so you can monitor the stock price for the three-and-a-half months leading up to April 15 and decide whether to hold or sell.

Quite frankly, we have seen many tax returns where the AMT was either never calculated or the credit wasn't being properly carried forward.

FACT 5: WITHOUT CAREFUL ATTENTION TO THE COMPLEXITY OF MANAGING STOCK-BASED COMPENSATION GRANTS, YOU CAN INADVERTENTLY LEAVE A LOT OF MONEY ON THE TABLE

Through the day's rush of events, keeping a close eye on the taxable events associated with stock-based compensation can seem like one financial task too far. When ignored, tax-advantaged events -- like the year and a day rule -- can be easily overlooked. The result: an inadvertent unrealized valuation of the stock-based compensation grant.

FACT 6: KNOWING WHEN TO HOLD YOUR OPTIONS IS AS IMPORTANT AS KNOWING WHEN TO EXERCISE THEM

In the case of ISOs, we recommend holding the stock option for at least a year and a day for the reasons described above.

NQOs are a bit more complicated. Sometimes it makes sense to exercise your NQOs sooner rather than later, given the fact that you will be paying taxes as ordinary income. Leveraging your purchase through a margin account might be advisable if you lack the wherewithal to pay for your shares in cash or through other shares you may possess.

How you attain the resources to buy the shares can be challenging to your cash flow situation. For leverage, you can borrow against the shares coming to you through a margin account. You can also use your current shares of stock to pay for new shares of stock. Sometimes a combination of stock and cash is preferable. If you use some of the shares to pay for shares, you are going to need to know the tax consequences there are as well.

DISCOVER MORE ABOUT MAXIMIZING THE BENEFITS OF STOCK-BASED COMPENSATION

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FACT 7: THE BEST TIME TO TAKE ACTION IS NOW. YOU DON'T HAVE TO FACE YOUR STOCK-BASED COMPENSATION CHALLENGES ALONE

Simply put. There's no percentage in waiting. Once our executives made the decision to act, they were surprised how easy it was to gather up the grant paperwork, place it in an envelope and send it to a financial advisor who specializes in executive compensation issues.

Financial advisors who concentrate in the stock-based compensation area can also function like equity consultants and run model scenarios to determine the time value of each of the grants. Knowing when to exercise is the critical decision that counts the most. Cash flow is key, of course. One of our chief objectives with clients is to play through their stock purchasing issues so some other cash flow problem doesn't crop up somewhere else. Of course, executives who are transitioning from a company have an even tighter timeframe: they need to exercise in 90 days from their termination date.

While options are a tool to manage some of your other goals, life doesn't begin and end with the options planning process. It is important to always view your compensation and the rest of your resources from as holistic and inclusive a perspective as you can.

Stock option grants have increasingly come to play a major role in the pay of top executives. Option grants are one of the best compensation mechanisms businesses have for getting managers to act in ways that ensure the long-term success of their companies and the well-being of workers and stockholders.

Congratulations, you've earned your stock-based compensation. The time to realize their full value has never been better.