STOCK OPTION STRATEGIES

Stock options allow you to benefit from an increase in the value of your employer's stock without putting your own money at risk; you hold the options until you think the stock price has reached a high, then exercise and sell—or hold—those shares. But how and when should you exercise your options? There are several factors to consider, including taxes, your financial circumstances, and how you expect the company and its stock to perform in the future.

Taxation of stock options

Nonqualified stock options (NQSOs). When you exercise NQSOs, the spread—the difference between the fair market value of the stock and the exercise price you pay—is taxable as ordinary income. Your employer is required to withhold federal, state, and FICA taxes on the sale of NQSOs, whether you hold onto the shares or sell them immediately after exercise.

Incentive stock options (ISOs). With ISOs, the spread is not immediately taxable as ordinary income; however, it is a preference item that is included as income for the purposes of calculating the alternative minimum tax (AMT).

The spread is taxed as a long-term capital gain if you hold the shares from an ISO exercise for at least two years *after* the grant date and at least one year after exercise. If, however, you sell the shares *before* two years after the grant date or *before* one year after exercise, you have a disqualifying disposition; this means that the gain at sale, up to the spread at exercise, is taxable as ordinary income. ISO spread is not subject to FICA, and your employer is generally not required to withhold taxes when you exercise ISOs; you should pay the tax by increasing the withholding on your other income or through estimated tax payments.

How to exercise your options

Your company may offer several different methods for exercising your options. Following are some of the alternatives you may be able to choose from.

Cash. Cash is probably the easiest method to understand. You transfer money to your employer to cover the exercise price and costs (brokerage commissions and fees). If the options are NQSOs, you must also cover the federal, state, and FICA taxes on the spread. The cash method may be good for an investor who has cash available and wants to hold onto the stock after exercise. If you would have to sell other positions or take a loan to obtain the cash, you should first consider the risks—tax implications, costs, and opportunity costs—of doing so, compared to the risks and benefits—dividends and increase/decrease in value—of holding company stock.

Cashless sell-to-cover. If you want to hold company stock but don't want to use cash, you might consider a cashless sell-to-cover exercise. With this method, you exercise your options and simultaneously sell enough shares to cover the associated price, costs, and taxes. If your options are ISOs, the sale of shares to cover expenses will be a disqualifying disposition, and the spread will be taxed as ordinary income.

Cashless same-day sale. If you are only interested in the cash proceeds from the exercise and don't want to hold onto the stock, a cashless same-day sale may be right for you. This requires simultaneously exercising your options and selling the resulting shares, leaving you with the net proceeds in cash (sale proceeds minus exercise price, costs, and, if NQSOs, tax withholding) after the trade is settled.

Stock swap. If you already own company stock, you can use your existing shares as payment for the exercise. If you hold ISOs, before you exercise with a stock swap you will need to consider the disqualifying disposition rules discussed earlier. The tax consequences of a stock swap can be complex, so you should also consult a tax advisor for help making this decision.

When to exercise your options

Your timing will depend on the method you plan to use (cash, cashless, or stock swap) and how long you plan to hold onto the shares.

Generally, if you expect the value to increase over time, it makes sense to exercise stock options near the expiration date; you delay taxation until exercise and are less subject to the volatility of the stock price. Consult with your financial advisor to determine whether company stock is an appropriate part of your investment portfolio, to evaluate the expected performance of the company and its stock, and to determine whether an exercise would have you facing concentrated stock concerns.

To manage the tax consequences, you might also consider exercising your options gradually to spread the taxes over several years. Try to find a balance between tax management, your need for cash, and the value you get out of the stock option.

Summary

Check with your employer to learn about the exercise methods available to you and the process to follow to exercise your options. Be sure to keep copies of your exercise statements, 1099-B forms, W-2 forms, and 3921 forms (for ISO exercise) for income tax reporting.

CUMMINGS WEALTH MANAGEMENT GROUP
A BEACON TOWARD YOUR FINANCIAL SUCCESS

1275 Ben Sawyer Boulevard | Mt. Pleasant, SC 29464 | Phone: 843.884.9898 | Fax: 843.884.8798 | www.cummingswealth.com