

# Nonqualified Stock Options

<b>Topic:</b>	Tax Treatment of Nonqualified Stock Options
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<b>Executive Summary:</b>	The most common form of stock option is the nonqualified type. Below is a summary of their characteristics and tax treatment.

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Traditionally nonqualified stock options have been the single most popular form of equity compensation. Companies like them because they provide a flexible and efficient way to attract, retain and motivate employees (and other service providers, such as directors and consultants). Employees like them because they represent an opportunity to grow wealth, with tax consequences deferred until the year of exercise.

## How You Get Them

Nonqualified options are usually granted pursuant to a *stock option plan* that was adopted by the company's board of directors and approved by the shareholders. The board of directors, or a committee appointed by the board (usually called the *compensation committee*), may decide who receives the awards and the specific terms of the options. In some cases options are granted according to a formula.

## What You Will Receive

When a company grants an option it should provide certain documents. You should receive an *option agreement*, setting forth the specific terms of your option. If the option is issued under a plan, you should also receive a copy of the plan, which provides some general rules that govern all options. In many cases the company also provides a summary of the plan.

It's important to understand your rights under the agreement and the plan. You need to know:

- ❖ What is the earliest date you can exercise the option? Does it become exercisable in stages?
- ❖ What do you need to do when you exercise the option? Is cashless exercise available? Can you exercise using stock you own?
- ❖ When will the option terminate? Can you exercise after your employment terminates? What if you die while holding the option?

Make sure you keep these documents in a safe place. Be sure to review them from time to time for planning purposes. At a minimum, you want to think about your options before the end of each year to determine whether to exercise some or all of the options by December 31 as part of your tax planning.

**Note:** *Many companies, including some large corporations, are lax when it comes to option documents. You may be asked to sign an option agreement that says you've received a copy of the plan, even though you've never seen the plan. Insist on receiving a copy of all relevant documents.*

## Terminology

Here are some of the important terms used in connection with nonqualified options:

- ❖ You receive the option when the company makes a *grant* or *award*.
- ❖ You *exercise* an option when you take the action specified in the option agreement to buy the stock. Usually you have to fill out a form notifying the company that you are exercising the option and provide cash equal to the purchase price (and possibly cash to cover any withholding obligation).
- ❖ The *exercise price* (also called the *strike price*) is the amount you have to pay to purchase the stock.
- ❖ The *bargain element* (also called the *spread*) is the difference between the value of the stock and the exercise price. For example, if the value of the stock is \$24 and the exercise price is \$19, the spread is \$5. When the spread is a positive number, the option is *in the money*.
- ❖ Options are *under water* (or *out of the money*) if the exercise price is higher than the value of the stock. There is no particular tax significance to an option being under water, but the practical significance is that the option will not become valuable until the price of the stock recovers.

## Typical Terms

Companies have great flexibility in the terms they can offer for nonqualified options. Your option may differ from the typical option in a number of important ways. But it may be helpful to compare your option with the norm:

- ❖ The exercise price is usually set at (or near) the value of the stock at the time the option is granted.
- ❖ The option becomes exercisable over a period of several years.
- ❖ Cash payment is usually required at the time of exercise, but some companies make a form of "cashless exercise" available, and others will loan the money needed to exercise the option.
- ❖ The option expires ten years after it was issued, or earlier if employment terminates. You may or may not have an opportunity to exercise options that are already vested (exercisable) at the time employment terminates. Options that are not exercisable at that time typically expire.

## Tax Issues at Receipt of Nonqualified Stock Option

With rare exceptions, there's no tax to pay, and nothing to report, at the time you receive a nonqualified option. The exceptions:

- ❖ You receive an option that's actively traded on an established securities market.
- ❖ You receive an option that has a "readily ascertainable value" as defined in the regulations. In our extensive experience, we've never seen an option that meets the stringent tests to have a "readily ascertainable value."
- ❖ The option is "in the money" to such a great extent at the time you receive it that the option is considered equivalent to owning the stock. For example, at a time when the stock is worth \$40 per share you receive an option that permits you to buy the stock for \$2 per share. (This exception would not apply to an option that was only slightly in the money — for example, an option with an exercise price of \$35 that is issued when the stock value was \$40.)

In all other cases you have nothing to report at the time you receive an option. This is true even if the option is fully vested when you receive it.

## Exercising Nonqualified Stock Options

Your nonqualified stock option gives you the right to buy stock at a specified price. You *exercise* that right when you notify your employer of your purchase in accordance with the terms of the option agreement. The precise tax consequences of exercising a nonqualified stock option depend on the manner of exercising the option. But in general you'll report *compensation income* equal to the *bargain element* at the time of exercise.

The *bargain element* in the exercise of an option is the difference between the value of the stock on the exercise date and the amount paid for the stock.

**Example:** You have an option that gives you the right to buy 1,000 shares of stock for \$15.00 per share. If you exercise the entire option at a time when the value of the stock is \$40 per share, the bargain element is \$25,000 (\$40,000 minus \$15,000).

The value of the stock should be determined as of the date of exercise. For publicly traded stock the value is usually determined as the average between the high and low reported sales for that date. For privately held companies the value must be determined by other means, perhaps by reference to recent private transactions in the company's stock or an overall appraisal of the company.

The bargain element in the exercise of an option received for services is considered *compensation* income. In the example above, you would report \$25,000 of income, just as if the company had paid you a cash bonus of \$25,000. You're not allowed to treat this amount as capital gain. The amount of tax you'll pay depends on your tax bracket. If you exercise a large option, it's likely that some of the income will be pushed up into a higher tax bracket than your usual one.

The important thing to focus on — ahead of time if possible — is that you have to report this income, and pay the tax, even if you don't sell the stock. You haven't received any cash; in fact, you *paid* cash to exercise the option, but you still have to come up with *additional* cash to pay the IRS. This is one reason advance planning is important in dealing with options. Please note that if you are an employee, the company is required to withhold taxes when you exercise the option.

*The information contained herein is of a general nature and should not be relied upon without first consulting a financial advisor. If you would like further information please email [info@vantagefinancial.com](mailto:info@vantagefinancial.com).*

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