



Employee Stock Options

BY MICHAEL FOMUKE

SEPTEMBER 2023

Stock compensation plans offer significant opportunities for wealth accumulation. However, the complexity of these plans and the diversity of how they can be structured can often lead to confusion. Managing equity awards requires a thoughtful strategy around maintaining an individual's liquidity, mitigating single asset exposure, and addressing tax concerns.

As with any wealth strategy, it's imperative to consider an individual's overall financial and personal situation when determining the optimal approach and timing for acquiring, holding, and realizing these positions. At NewEdge Wealth, we offer clients guidance on equity-based compensation, helping executives understand and navigate these elements within their overall compensation packages. Our thorough analysis encompasses an examination of compensation plans alongside each client's unique financial circumstances to determine the package's actual value and the impact the positions could have on their wealth, taxes, and estate plans.

Our team has developed this comprehensive guide designed to educate our clients on the intricacies of structures, strategies, and considerations when participating in equity compensation programs. Much like other financial instruments, Restricted Stock Units (RSUs), Incentive Stock Options (ISOs), and Non-Qualified Stock Options (NQSOs) come with a certain degree of complexity that, when managed correctly, can be leveraged to your advantage.





Incentive Stock Options (ISOs) vs. Non-Qualified Stock Options (NQSOs)

Two of the more common stock compensation packages are based on either Incentive Stock Options or Non-Qualified Stock Options. Comparing ISOs vs. NQSOs involves understanding the key differences in each plan regarding eligibility, tax treatment, benefits, and limitations. Both types of employee stock options have distinct characteristics that make them suitable for different scenarios.

Let's explore the comparisons between ISOs and NSOs below:

Eligibility

- **ISOs:** ISOs are typically granted to key employees and executives, providing an incentive to retain top talent and align their interests with the company's success. There are limitations on the maximum value of ISOs that can be granted to an employee in a given year.
- **NQSOs:** NQSOs are more flexible in terms of eligibility and can be granted to a broader range of employees, including executives, non-executives, and consultants.

Exercise Price

- **ISOs:** The exercise price (strike price) of ISOs is set at the market price of the company's stock on the grant date. This ensures that employees benefit from any appreciation in the stock price between the grant date and the exercise date.
- **NQSOs:** Instead of the market setting the price of the stock as is the case with ISOs, the exercise price of NQSOs is determined by the company itself and is not required to match the market price on the grant date.

Tax Treatment

- **ISOs:** ISOs offer potential tax advantages if certain holding period requirements are met. Employees who hold ISO shares for at least one year from the exercise date and two years from the grant date may qualify for long-term capital gains tax rates upon selling the stock. *It is important to note, while exercising ISOs is not a regular taxable event, the bargain element is an AMT adjustment item.*
- **NQSOs:** NQSOs are subject to ordinary income tax rates on the difference between the exercise price and the market price at the time of exercise. Employers are also required to withhold payroll taxes, adding to the immediate tax burden.



Holding Period

- **ISOs:** ISOs have specific holding period requirements to achieve favorable tax treatment. The gain may be subject to ordinary income tax rates if these holding periods are not met.
- **NQSOs:** NQSOs do not have the same holding period requirements for favorable tax treatment. However, the timing of exercise and sale can impact the tax consequences.

Employer Reporting

- **ISOs:** Employers are not required to report ISO exercises to the IRS on the employee's Form W-2.
- **NQSOs:** Employers are required to report NQSO exercises on the employee's Form W-2, which can impact tax withholding.

Compensation Limitations

- **ISOs:** ISOs are subject to annual limits on the maximum value of options that can be granted to an employee.
- **NQSOs:** NQSOs do not have the same limitations as ISOs, providing companies with more flexibility in designing compensation packages.

Use Cases

- **ISOs:** ISOs are often used to incentivize key employees and executives, providing potential tax advantages in exchange for longer holding periods.
- **NQSOs:** NQSOs are commonly used to offer a broader range of employees a stake in the company's success, with more flexibility in terms of tax treatment and exercise timing.

In summary, ISOs and NQSOs differ in terms of eligibility, tax treatment, exercise price, and benefits. ISOs offer potential tax advantages but come with stricter requirements, while NQSOs provide greater flexibility and are available to a wider range of employees. NewEdge Wealth can help individuals and companies make informed decisions based on their specific circumstances.

Various considerations related to Employee Stock Options (ESOs)

Now that we've broken down the differences between ISOs and NQSOs, let's look at various considerations that can be considered.

Exercise and Hold Strategy: This strategy involves exercising ESOs and holding onto the acquired shares for an extended period, often intending to benefit from potential long-term stock price appreciation. This approach aligns with the requirements for favorable tax treatment, particularly for ISOs. Under current tax laws, by holding the shares for the prescribed holding periods, employees can qualify for lower long-term capital gains tax rates when they decide to sell the stock.

Exercise and Sell Strategy: In this strategy, employees exercise their ESOs and immediately sell the acquired shares. This approach can be particularly attractive if the employee needs liquidity or wishes to diversify their investment portfolio beyond the concentrated position these shares represent. However, it's important to consider the immediate tax implications of this strategy, as the gain from the option exercise will likely be subject to ordinary income tax rates, rather than long-term capital gains tax rates.

Exercise and Hold for Diversification: This strategy involves exercising a portion of ESOs and holding the acquired shares while selling another portion to achieve diversification. Employees can benefit from future stock price appreciation by holding onto some shares, while selling a portion provides immediate liquidity and reduces concentration risk.

Tax Planning Strategy: ESOs come with complex tax implications. Developing a tax planning strategy is crucial to managing the potential tax burden associated with exercising and selling ESOs. Engaging with professionals can help employees make informed decisions about when to exercise options to optimize tax outcomes.

Vesting and Timing Strategy: Carefully managing vesting schedules and exercising options at strategic intervals can optimize the financial impact of ESOs. Waiting for options to vest before exercising can ensure that employees capture the full value of their compensation over time.

Risk Mitigation Strategy: Given the potential volatility of stock prices, employees may want to employ strategies to mitigate risk. This could involve staggering option exercises over time or using option collars to limit potential losses.

Evaluation of Company Performance: Before exercising ESOs, employees should evaluate the company's financial health, growth prospects, and overall performance. This analysis can guide decisions about when and how to exercise options to maximize potential gains.

Wealth Strategy and Goal Alignment: ESOs are an integral part of an employee's overall financial portfolio. Integrating ESOs into a broader wealth strategy ensures they align with personal financial goals, risk tolerance, and investment strategy.

Consideration of Life Events: Life events, such as changes in marital status, estate planning, and retirement, can impact ESO strategies. Adapting ESO plans to align with these events ensures a holistic approach to financial management.

NewEdge Wealth offers a range of valuable services to assist clients in navigating the world of employee stock options (ESOs). Our expertise encompasses a deep understanding of ESOs, allowing us to provide guidance on optimal exercise strategies and effective tax optimization. We seamlessly integrate ESOs into a client's broader wealth strategy, ensuring alignment with their financial goals. With a focus on diversification, we help manage risk by developing well-informed strategies. Our team provides decision-making support, tailored to each client's unique circumstances and offers customized approaches that suit their needs. We also provide behavioral guidance to help clients stay on track and make rational choices. Additionally, we diligently monitor market dynamics and make necessary adjustments to an ESO strategy to ensure its continued effectiveness.

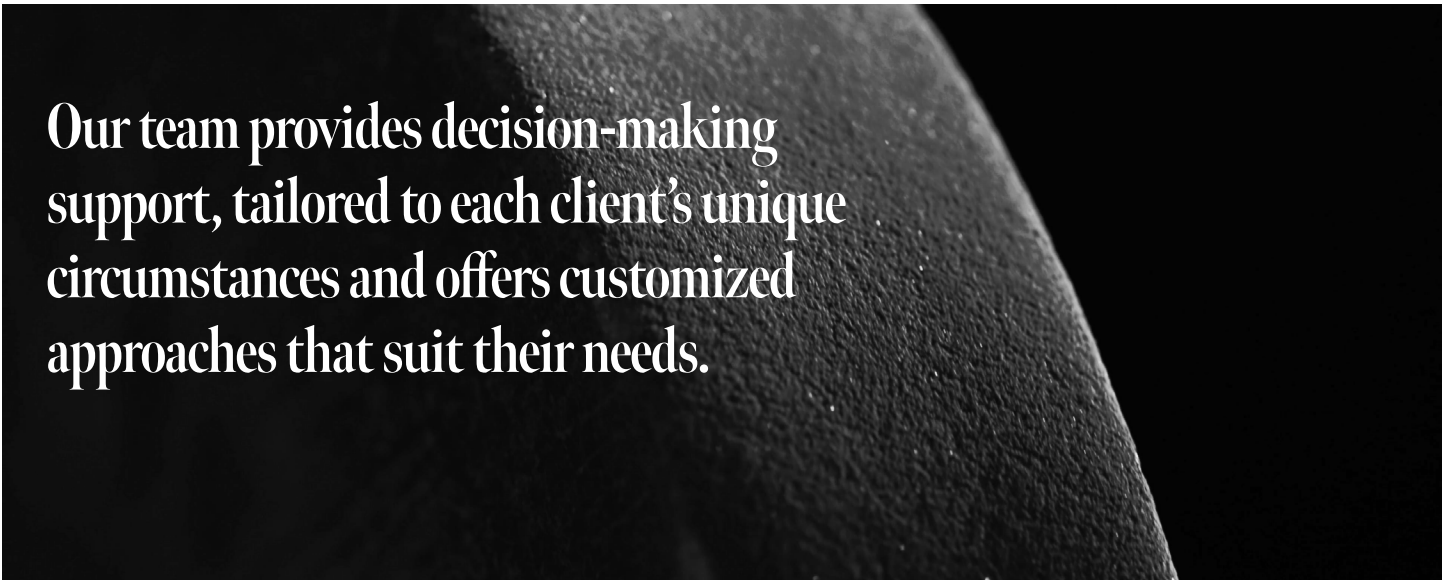
Case Study 1: Overlooking the Alternative Minimum Tax (AMT) Impact

Imagine you are an employee whose company granted Incentive Stock Options (ISOs). Excited about the potential for future gains, you decide to exercise your ISOs when the stock price is rising. However, you overlook the potential impact of the Alternative Minimum Tax (AMT).

In this scenario, exercising ISOs triggers an AMT liability you were unprepared for. The AMT is a parallel tax system with its own rules and rates. It aims to ensure that individuals who benefit from certain tax deductions and exemptions still pay a minimum level of tax. When you exercise ISOs, the difference between the stock's fair market value and the exercise price is considered an AMT preference item, potentially increasing your AMT liability.

Due to the substantial gain from exercising your ISOs, your AMT liability surpasses your regular tax liability. As a result, you owe significantly more taxes than you anticipated, impacting your overall financial situation. This unexpected tax burden can strain your finances, erode the gains you expected from your ISOs, and lead to frustration and stress.

This scenario underscores the importance of understanding the potential tax implications of ISOs, including AMT. NewEdge Wealth can help avoid unwelcome surprises and ensure that your ISO strategy aligns with your financial goals.



Our team provides decision-making support, tailored to each client's unique circumstances and offers customized approaches that suit their needs.

Case Study 2: AMT Liability After Exercising ISOs and Stock Price Drop

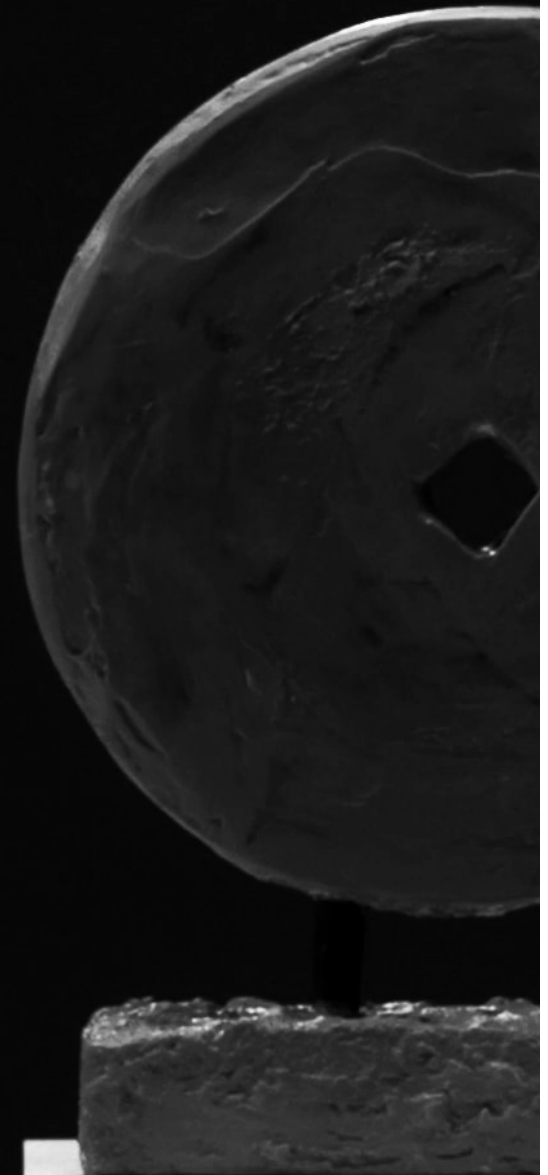
Picture yourself as an employee who holds Incentive Stock Options (ISOs) from your company. You've been watching the stock's performance closely and have a positive outlook. Believing that the stock will continue to rise, you decide to exercise a substantial portion of your ISOs and purchase the company's stock at the current market price.

Unfortunately, shortly after you exercise your ISOs and acquire the shares, the company's stock experiences an unforeseen and significant decline due to unexpected market factors or internal challenges. The stock price plummets, and the value of the shares you acquired drops significantly below the exercise price you paid.

To make matters worse, at tax time, you realize that you triggered the Alternative Minimum Tax (AMT) when you exercised your ISOs, even though you're now facing a substantial unrealized loss on the stock. The difference between the fair market value of the shares at exercise and the exercise price is still considered an AMT preference item, contributing to your AMT liability.

You find yourself in a challenging situation where you exercised ISOs, acquired shares at a higher price, faced a significant paper loss due to the stock's drop, and now have an unexpected AMT tax bill to pay. This scenario highlights the complex interplay between exercising ISOs, stock price fluctuations, and AMT implications.

The lesson here is the importance of thorough tax planning and understanding the potential risks involved when exercising ISOs. It also underscores the need to consider not only the market outlook but also the potential tax consequences of your actions. Seeking advice from professionals can help you navigate these complexities and make informed decisions that align with your financial goals while minimizing potential adverse outcomes.



Important Disclosures

NewEdge Wealth is a division of NewEdge Capital Group, LLC. Investment advisory services offered through NewEdge Wealth, LLC, an investment adviser registered with the US Securities and Exchange Commission. Securities offered through NewEdge Securities, Inc. Member FINRA/SIPC.

The views and opinions included in these materials belong to their author and do not necessarily reflect the views and opinions of NewEdge Capital Group, LLC.

This information is general in nature and has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy.

NewEdge and its affiliates do not render advice on legal, tax and/or tax accounting matters to clients. Any investment, tax, marketing, or legal information contained herein is general and educational in nature and should not be construed as advice. Please consult your tax advisor for matters involving taxation and tax planning and your attorney for matters involving trusts, estate planning, charitable giving, philanthropic planning, and other legal matters.

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results.

All data is subject to change without notice.

© 2023 NewEdge Capital Group, LLC



WWW.NEWEDGEWEALTH.COM