MAKING THE MOST OF YOUR EMPLOYEE STOCK OPTIONS

By Gary Case

Like many employees, you may have received stock options as part of your compensation package. To make the most of your options, you should know the federal tax consequences of receiving an option, exercising it, and eventually selling the stock.

A stock option allows employees to purchase company stock at what is generally a discounted price. It specifies the number of shares, the price, and the time frame within which the employee can exercise the option. A stock option may be either a nonqualified option or an incentive stock option.

Nonqualified Stock Options

When a nonqualified option is granted, you generally are not considered to have received any income. Unless the value of the option is "readily ascertainable" upon receipt, you won't owe income tax until you exercise the option. Once a nonqualified option is exercised, you must recognize ordinary income equal to the difference between the fair market value of the stock and the exercise price.

You'll owe tax on that income at regular federal income-tax rates, which in 2003 range from
10% to 35%*. If you later sell the stock, you'll owe tax on only the capital gain realized over
the fair market value at the time you exercised the option. That gain will be taxed at a maximum
15% capital gains rate as long as you've held the stock for more than a year.

Incentive Stock Options

With incentive stock options (ISOs), neither the receipt nor the exercise of the option is a taxable event. Instead, income is recognized when you sell the stock. As long as you hold the stock

acquired in the exercise for more than a year and don't sell it within two years after the option is granted, any increase in the value over the exercise price is taxed at the capital gains rate. However, depending on your personal circumstances, you may find yourself subject to alternative minimum tax (AMT) in the year the option is exercised. Consult your professional financial advisor for more details.

Planning Your Options

How should you plan to handle your stock options? Provided your options had no readily ascertainable value at grant, delaying exercise of your options can make sense if the stock's price is increasing. You'll benefit from rising stock prices without tying up your cash in the stock. If you want to make sure your family will benefit from the stock options even if you die before exercising them, you can purchase life insurance in an amount equal to the stock's value.

On the other hand, if you think the stock's price is peaking, you may want to exercise your options as early as possible. Similarly, if you are getting close to retirement age and own — or have the potential to own a high concentration of company stock, consider exercising options now and gradually selling the company stock in order to diversify your portfolio in preparation for retirement.

Talk with your professional financial advisor. He or she can help you integrate your stock options into your overall investment program.

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