

**info sheet**

**Employer Stock Option Basics**

Many companies now include stock option plans as an employee benefit and part of the company's overall compensation package. These companies frequently view their stock option plans as a performance-based incentive and hope that giving employees a financial stake in the company's growth and performance will increase employee motivation, satisfaction, performance, and loyalty.

If you are eligible to participate in an employer stock option plan, it is important to be familiar with both the general rules relating to these plans and also to the specific rules which are individual to your plan. Companies frequently design their own stock option plans and therefore plan rules and features can and do vary widely from one company to another. The following is a general discussion of concerns that you may have with respect to your participation in an employer stock plan.

**What is a Stock Option?**

A stock option is the right to purchase a designated number of shares of stock at a pre-determined price (or formula) during a specified period of time. An option is valuable because it allows a risk-free way to lock into a purchase price and as the market price of the stock rises, the value of your option also rises. For example, if you are granted an option to buy 100 shares of employer stock at \$25 per share, and the stock subsequently rises to \$40 per share, the value of your option at that time (i.e., the growth in the share value you would realize if you purchased the stock and immediately sold it) is \$15 per share.

**What are the different types of employer stock option plans?**

There are two basic types of employer stock options (often offered under a single plan): Incentive Stock Options (ISOs) and Non-Qualified Stock Options (NSOs).

An **ISO** is an option to buy employer stock at a future date at a price equal to the full fair market value of the stock at the time the option is granted. The primary benefit of an ISO is that the employee receives equity compensation from the company and will potentially be taxed at favorable long-term capital gains rates. Neither the grant nor the exercise of an ISO is a taxable event under federal income tax law. Thus, at the time you exercise the options, you will not have to pay any federal income tax, unless you are subject to Alternative Minimum Tax, or AMT. Taxpayers who are subject to AMT must include their ISO "spread" as income. In the above example, the spread would be \$1,500 (\$15 per share x 100 shares). For everyone else the first time you will have a taxable event is when you sell the shares.

If you have a "qualified disposition" you will pay tax, at favorable capital gains tax rates, on the difference between the grant price and the price at which you sell (or otherwise dispose of) the stock. In order to have a qualified disposition you must hold the stock for at least two years from the date the option is granted and at least one year from the date the option is exercised. ISOs also carry numerous other restrictions for both employers granting the options and the employees who exercise them. As a result of these restrictions, ISOs are less commonly granted than NSOs.

An NSO may be granted at any price an employer chooses, including a price that is below market value at the time of the grant. At the time you exercise an NSO (unless the shares are subject to a substantial risk of forfeiture), the difference between the exercise price and the fair market value per share on the date of exercise will be included in your gross income for federal income tax purposes and taxed as ordinary income. When you sell your stock, any appreciation after the exercise date will be taxable as capital gain.

## **What is vesting?**

Many employer stock options are subject to a vesting schedule. Most commonly, a vesting schedule dictates when you are first able to exercise your options. There are many different types of vesting schedules but the following four types are the most common. Additionally, some options have special rules for employees who retire, die, or become disabled prior to the date their options are vested.

- **Straight Vesting**

Straight vesting is also referred to as percentage vesting. A certain percentage of your option vests each year, usually on either the anniversary date of the grant or on some other fixed date such as January 1. For example, if your option has a 5 year straight vesting schedule, then 20% of your option vests each year.

- **Cliff Vesting**

Cliff vesting occurs all at once at a specific time. If your option has five-year cliff vesting, then you will become 100% vested in your option on the fifth anniversary of the grant date. If you terminate your employment at any time prior to that anniversary, you generally will be unable to exercise any of your option.

- **Step Vesting**

Under a step vesting schedule your option vests at a different specified percentage for each year. For example, the option might vest 5% in the first year, 10% in the second year, 25% in the third year and an additional 30% in each of the fourth and fifth years.

- **Performance Vesting**

Under a performance vesting schedule, your option will vest when a specified corporate goal is reached. For example, your options may vest when the company reaches a certain annual profit level or when an initial public offering is announced. Sometimes there also will be a final date on which the option will vest even if the performance goals are not achieved.

## **When can you exercise your options?**

Although options vary as to when they may be exercised, most options are exercisable any time after they vest and before they expire. Most options expire within 10 years from the grant date.

**What are the major risks associated with stock option plans?**

Stock option plans can have substantial risks associated with them. The first risk is that, once you exercise your options, you may be under-diversified. If you have too much of your investments tied up in your employer's stock, you might have "too many eggs in one basket". If the stock goes down in the future, you may not have enough other investments to balance out the effect of the stock decline. The second risk, which is common to all stock holdings, is the risk that the value of the stock will decline over time instead of appreciating. Another risk would be failing to exercise your options and letting them expire, thereby missing out on the potential value of this benefit entirely. Additionally, there may be risks associated with termination of your employment, especially if you are holding unvested or unexercised options.

With your investment professional's help, many of these risks can be managed. Participating in an employer stock option plan can be beneficial to you. You may stand to recognize personal wealth and increased job satisfaction from participating in your employer's plan.

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