EMPLOYEE STOCK OPTIONS

DEFINITION

Employee stock options are an incentive that companies use to compensate, retain, and attract employees. They are contracts between a company and its employees which give employees the right to buy a specific number of the company's shares at a fixed (strike) price within a certain period of time. Employees who are granted stock options hope to profit by exercising their options at a higher price than when they were granted. Although it is essentially a call option on the common stock of a company, granted by the company to an employee, an employee stock option is slightly different from a regular exchange-traded option because it is not generally traded on an exchange. In addition, employees typically must wait a specified vesting period before being allowed to exercise the option.

HOW THEY WORK

EMPLOYER ADVANTAGES

An employer's objective in offering stock options is to align incentives between the employees and shareholders of the company. The hope is that employees will behave in ways that will boost the company's stock price. The shareholders' goal is to see the stock's share price appreciate, so rewarding employees when the stock goes up increases the chances that everyone is striving for the same goals. Additionally, by placing restrictions on the option, such as vesting and limited transferability, employees' interests will be for the long term health of the company.

Employee stock options are mostly offered to management as part of their executive compensation package, but they may also be offered to non-executive level staff. This is the case especially for businesses that are not yet profitable, as they may have few other means of compensation. These stock options can also be offered to non-employees like suppliers, consultants, lawyers and other professionals for services rendered.

EMPLOYEE ADVANTAGES

Employee stock options carry the right, but not the obligation, to buy a certain amount of shares of a company at a predetermined price. If the company's stock price rises above the stated strike price, the employee would exercise the option. They can then sell the stock, benefitting by the difference between the share price paid (the strike price) and the price they were able to sell the shares at on the open market. If the stock price never rises above the stated strike price by the time the option needs to be exercised, the employee is not obligated to exercise the option, in which case it will lapse and the employee will owe nothing.

VESTING

Before an employee can exercise the stock options, they must fulfill a "vesting schedule." They must wait a stated period of time before their options are vested, or fully owned, by the employee. Some option grants may vest after just one year. However, most grants follow a graduated vesting schedule, where the employee is entitled to a progressively greater percentage of options each year. For example, 25% of the total shares may be exercisable after one year, 50% after two years, 75% after three, and full vesting after the fourth year. Most options are fully vested after the third or fourth year.

EXERCISING

Once an employee's options are vested, they have three main ways to exercise them. They can pay cash for the shares, swap employer stock they already own, or doing a cashless exercise (simultaneously selling enough shares to cover their costs). The dollar amount the employee will owe is the strike price multiplied by the number of shares. Usually, the strike price is equal to the stock's market value at the time the option is granted. However, it can be lower or higher than that, depending on the type of option. In the case of private company options, the strike price will be stated at issuance based on an internal valuation metric. When the employee exercises the options, the current value of the shares will be based on the same metric.

TAXATION

Most employee stock options are non-transferable, and are not immediately exercisable. Because of this, the IRS considers that their fair market value cannot be readily determined, and no taxable event occurs when an employee receives an option grant. Upon exercising the grant, the employee may or may not be taxed depending on the type of option granted. There are two basic types of options:

- Incentive Stock Options (ISOs) - these qualify for special tax treatment, as gains may be taxed at capital gains rates instead of higher ordinary income rates. If the shares are held for one year from the date of exercise and two years from the date of grant, then any profit made on sale of the shares is taxed as a long-term capital gain. In the event that these holding periods are not met, the options are then subject to a disqualifying disposition, and are treated as non-qualified stock options for tax purposes.

- Non-Qualified Stock Options (NQSOs) – these are taxed upon exercise and result in additional taxable income to the employee at the time that they are exercised. The amount to be included as income is the difference between the strike price and the market value on that date. This type of option is frequently preferred by employers because the issuer is allowed to take a tax deduction equal to the amount the employee is required to include as income.