# Thinking Strategically about Stock Options

Stocks options are an integral part of many executive compensation programs and can represent a significant portion of an executive's total wealth. Relative to the ownership of shares, however, stock options involve unique risk and return opportunities, as well as special tax considerations and time factors. It is vital for executives to fully understand these factors and incorporate the stock options into their portfolios and overall wealth management strategies.

**Tax Implications - ISOs vs. NSOs**
Thinking strategically about stock options requires understanding the tax implications of exercising the options. These tax implications can significantly affect the cash flows and timeframe associated with excising and holding the stock. The tax rates (ordinary income vs. long-term capital gains) and the timing of income recognition (at the time of exercise or upon sale of the stock) depends on whether the stock options are incentive stock options or nonqualified stock options.

*Incentive stock options (ISOs)*
Stock options that qualify for potentially favorable tax treatment are referred to as incentive stock options (ISOs). To qualify for these tax benefits—no recognition of income upon exercising the option and long-term capital gains treatment when the stock is sold—the owner must hold the stock for at least one year after excising the option and at least two years from when the option was granted. Any sales before the end of the waiting period, however, will generate ordinary income on the difference between the fair market value at the time of exercise and the strike price.

The tax benefits of ISOs can be negated if the owner is subject to the alternative minimum tax (AMT). It is important to work with your tax advisor to determine the total tax liability of exercising options under different scenarios.

*Nonqualified stock options (NSOs)*
Stock options that do not qualify for favorable tax treatment are referred to as nonqualified stock options (NSOs). Upon exercising an NSO, the owner must pay ordinary income tax, as well as Social Security and Medicare taxes, based on the difference between the stock's fair market value at the time of exercise and the option's strike price.

**Factors to consider with stock options**
Given the unique characteristics of stock options, there are several questions to consider when incorporating options into a wealth management strategy.

*Current and future liquidity needs*
- How would exercising the options affect your cash flow?
- Do you view the options primarily as an opportunity to generate near-term gains or long-term appreciation?

*Portfolio composition and diversification*
- How do the underlying shares affect the asset allocation and diversification of your existing portfolio?

*Tax treatment*
- What are the tax implications of exercising the options and selling or holding the underlying stock? (See "ISOs vs. NSOs" for more information.)

*Risk tolerance*
- Are you comfortable with the risk/return implications of owning a large position of stock or would you prefer to diversify those assets?

*Timeframe*
- When do the options expire?
- What are your expectations for the performance of the company during this timeframe?

**Exercising Stock Options**

There are three primary methods for managing stock options. These three methods can be used separately or in combination to create a customized strategy that aligns your equity position with your tax situation, risk tolerance, cash flow needs, time frame, and expectations for the company's future performance.

| | Description | Advantages | Disadvantages |
|---|---|---|---|
| **Hold options** | Hold the options until you believe the time is right to sell; keep in mind that all options have no value after their expiration date | Full participation in future appreciation of underlying stock; defers tax recognition | No downside protection or diversification opportunities; no benefits of being a stock owner (dividends or voting rights); "time value" of options decreases as expiration date nears |
| **Cashless exercise** | Exercise options and sell all or a portion of the shares to cover the purchase price, taxes, and brokerage fees | No cash outlay; benefits of stock ownership (dividends and voting rights); participation in stock price appreciation for the shares held; diversification opportunities | Number of shares owned is reduced to cover purchase and transaction costs; stock price may drop below exercise price |
| **Exercise and hold** | Exercise the options using cash provided by the owner | Benefits of stock ownership (dividends and voting rights); participation in stock price appreciation; no reduction in number of shares owned; diversification opportunities | Initial cash outlay to cover purchase and transaction costs; stock price may drop below exercise price |

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