CORE FINANCIAL CONCEPTS
Financial Education at Work

Employee Stock Options: 1, 2, 3

By Jeff Nordin, MBA, CFP®, CAP®, CLU®

Most employees aren't taught much about their employee stock options. And unfortunately, most of what's out there on the internet falls somewhere between confused and wrong. Plus, it's often put forth by someone with no expertise in the subject or by someone with conflicts of interest. The following is an unbiased guide to your employee stock options…

Stock

Owning a share of stock in a company makes you an owner of that company.

If you own a share of Apple stock, you are a part owner of Apple Incorporated. If you own a share of stock in a private company called Digital Widget, you're a part owner of Digital Widget.

For public companies like Apple, the price of a share is determined in public stock markets between buyers buying and sellers selling. For private companies like Digital Widget, the price (also called fair market value or FMV) of a share is determined by an independent valuation firm the company hires each year to perform what is often referred to as a "409a valuation" for the Internal Revenue Code Section involved.

Options

An option is the right, but not the obligation, to buy a share of stock at a specified price for a specified period of time.

An employee stock option allows you to, but doesn't require you to, pay the exercise price for a share of your company's stock until your employee stock option expires. And, you get to pay the exercise price for a share regardless of what the share price is at the time.

There are two types of employee stock options: Incentive Stock Options (ISOs) and Non-Qualified Stock Options (NQSOs or NSOs). They work the same way, but ISOs may get more favorable tax treatment.

Spread

The spread = the share price - your exercise price.

If the price of a share of company stock is currently $7 and your exercise price is $5, then $7 - $5 = a $2 spread. Exercising one of your employee stock options at that point would allow you to pay $5 to get a share that's worth $7. Your exercise price doesn't change, and you'd like the share price to increase over time; you want the spread to get larger.

Key Dates

There are 5 key dates for employee stock options.

Grant Date

When you're awarded your employee stock options. Usually when you're hired - you're awarded, or granted, employee stock options by the company's board of directors. "Digital Widget is giving me a great salary, amazing health benefits, and they're granting me 4,000 employee stock options!"

Vest Date
When you've met the criteria (usually based on time as an employee at the company) set forth by your employer to control and be able to exercise your employee stock options. "I've now been at Digital Widget for a year, and 1,000 of my employee stock options have vested!"

Exercise Date
When (if) you choose to use your employee stock options to buy shares of stock in your employer. You can exercise any or all of your vested employee stock options. "I just exercised 500 of my 1,000 vested employee stock options and so I now own 500 shares of Digital Widget stock!"

Note: the spread at the time you exercise an employee stock option is a consideration for income taxes.

Sale of Stock Date
When you sell a share of stock that you got from exercising your employee stock options. At a public company, you can readily sell shares in public stock markets. At a private company, you'll typically only be able to sell shares after there's been a liquidity event - a sale of the company or an initial public offering (IPO). "At the end of the lockup period after Digital Widgets' IPO, I sold 500 shares of my stock for a gain!"

Note: the amount of gain (or loss) from the sale of a share of stock is a consideration for income taxes.

Expiration Date
When your employee stock options are no longer usable (often 10 years from your grant date).

Considerations 1, 2, 3

1. Exercising your vested employee stock options means you are spending your own money to buy shares. At a private company, you're risking your own money - many private companies "cease operations", and many more never have a liquidity event.

2. The probability of a private company having a liquidity event is lower earlier and higher later. Three founders who launch their startup today have no idea if their company will ever have a liquidity event. Three founders whose company is scheduled to have an IPO next week are 99% certain there will be a liquidity event.

3. Income taxes on exercise of vested employee stock options are almost always lower earlier and higher later. Employees at a startup that launched a year ago may be able to exercise their vested employee stock options when there is very little or possibly no spread and pay very little or possibly no taxes. Employees that wait to exercise their vested employee stock options until their company has an IPO are likely to have a larger spread and likely to pay more in taxes.

Note: considerations 2 and 3 are in direct opposition to one another.

Conclusion

Employee stock options can provide a financial mechanism to participate in the success of your employer. Learn as much as you can about yours. Look for educational sources that have expertise in the subject and have no conflicts of interest.