

# Understanding employer-granted stock options

## *Important information for option holders*

***Employee stock options can be one of the most valuable benefits companies provide as part of a benefits package. However, the financial consequences of exercising them can be quite confusing and varied, depending on the features of the options that have been granted.***

This report will help explain how stock options are used as an employee benefit and how to differentiate between the types of options. You will also find helpful information about the tax consequences associated with exercising stock options and key terminology associated with stock options.

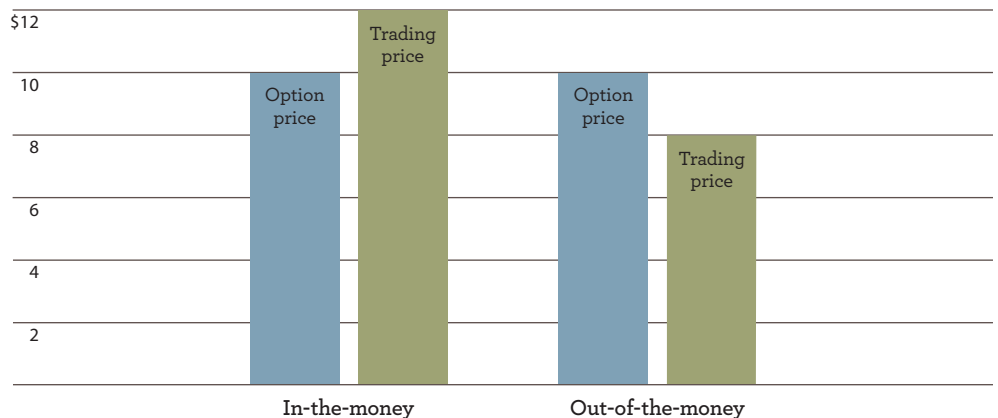
### What is a stock option?

An employer-granted stock option is the right to purchase a company’s stock in the future at a fixed price. As the company’s stock price appreciates, the option’s value also appreciates. By offering benefits tied to stock ownership, the company attempts to align an employee’s financial goals with those of the company’s shareholders.

When you exercise an option, you purchase shares of the company’s stock directly from the company. The grant price (also commonly referred to as the exercise price) is the amount you pay to the company for each share. This price is set by the company at the time the stock option grant is made (grant date).

### When should you consider exercising your option?

You would consider exercising an option only when it’s “in the money.” An option is considered to be in-the-money when the employer’s current stock price is higher than the grant price. An option is considered “out of the money” (or “underwater”) if the current stock price is below the grant price.



Another factor that may significantly affect the timing of your option exercises is the vesting schedule. Vesting refers to the date on which options can be exercised. By instituting a vesting schedule, an employer may require you to complete a period of service after the option has been granted before it can be exercised. As a result, vesting schedules help encourage continued employment.

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A vesting schedule may be graduated so that some percentage of the options becomes exercisable at regular intervals over a certain period. For example, a common vesting schedule requires that employees wait one year from the grant date before any of the options are exercisable. On the first anniversary of the grant date, 20% of the options can be exercised. Under this type of schedule, the remaining options will continue to vest at the rate of 20% per year for the next four years until all of the options are fully vested.

In contrast, a cliff-vesting schedule stipulates that the options will all become available to exercise at some future time. A common cliff-vesting schedule provides that none of the options granted can be exercised within the first three years following the grant date. On the third anniversary of the grant date, all of the options are immediately available for exercise.

Expiration dates refer to the end of an option's life. Stock options are usually granted for a specific period (option term) and must be exercised within that period. A common option term is 10 years, after which, the option expires.

You should be alert to the terms of your stock option plan with respect to any changes in these dates. For example, your company's plan's terms may dictate that if you separate from employment, that separation will accelerate your options' expiration date. It is common for plans to allow as little as 90 days to exercise any remaining options that have vested on or before the event date. These terms may treat different events in different ways. For example, a plan may provide different expiration dates if your separation is the result of termination, retirement, disability or death.

## Types of stock options

Stock options come in two forms: incentive stock options (ISOs) and nonqualified stock options (NSOs). The primary differences between the two types are how long the options can last before they expire and how you will be taxed.

### ISOs

There are no tax consequences to you when you are granted ISOs because no transfer of any property occurs on the grant date. To qualify as an ISO, the options must have a grant price that is not less than the stock price on the grant date and must have an option term of 10 years or less.

When an ISO is exercised, the grant price becomes your cost basis for the shares you receive. When you eventually sell these shares, the difference between the stock's selling price and your cost basis (typically grant price) is the income you must consider for tax purposes. As discussed next, the timing of your sale or transfer of these shares is critical for determining how you will be taxed.

Although there is no taxable event created when you exercise ISOs, there still are potential tax consequences. The difference between the stock price on the exercise date and your option cost represents the taxable spread. If you decide to keep the shares that you receive from an ISO exercise, this taxable spread will become a preference item for alternative minimum tax (AMT) purposes for the calendar year in which the exercise occurs.

## Special ISO-related issues

### Alternative minimum tax (AMT)

Although exercising an ISO does not result in immediate taxation, the taxable spread is a preference item for the AMT. If you hold the ISO shares beyond Dec. 31 of the year in which the option exercise occurs, this preference item will be included as part of your AMT calculation for each share that you continue to hold. If you sell the shares in the next calendar year, but before meeting the holding requirements, you can create a scenario in which the same taxable spread results in AMT liability in the year of exercise and ordinary income in the next year.

If you have large ISO grants, plan carefully so you can avoid stacking too many options to be exercised in any one year. Other factors must also be considered when determining whether your exercise may cause you to be subject to the AMT. Consult your tax advisor to determine whether and how the AMT may affect you and to help you plan ISO exercises. Careful planning may help limit your AMT exposure.

### \$100,000 rule

Vesting schedules are particularly relevant with respect to ISO grants. When a company grants ISOs, the combined value of all shares that can be exercised for the first time (i.e., vested) in any one calendar year cannot exceed \$100,000. The value is measured by the stock's value on the grant date. If the value of the vesting shares exceeds \$100,000, the excess portion will be denied ISO treatment and will be taxed similarly to NSOs.

When you sell stock received from ISO exercises, the timing of that sale becomes critical. As long as you have held the stock for the required holding period — at least one year from the exercise date and two years from the grant date — the entire difference between the stock's selling price and your cost basis will be taxed as a long-term capital gain. Currently, these rates are very favorable when compared with the tax rates for ordinary income (marginal tax rates). The greater the difference between the long-term capital gains tax rate and your marginal tax rate, the more attractive an ISO becomes. Individuals in lower marginal tax brackets may also be able to achieve tax benefits with ISOs because currently there is a lower long-term capital gains tax rate that applies to these individuals.

If you don't retain the stock for the required holding period (as defined above), you will not qualify for long-term capital gains tax treatment. This is referred to as a "disqualifying disposition."

If you "disqualify" your ISO shares, you will be taxed in a similar manner as with NSOs, discussed next. The taxable spread created upon the exercise of the options (stock price minus the grant price) will be taxed as ordinary income based on marginal tax rates. If the stock has appreciated since the exercise date, that appreciation will be taxed as a short-term capital gain. The chart on the following page contains a side-by-side comparison detailing the difference in tax treatment for ISOs that satisfy the holding period and those that are sold in a disqualifying disposition.

Another important feature associated with ISOs is the necessity of an ongoing relationship with the employer. If you have been granted ISOs and your employment

## Typical tax treatment of an ISO<sup>1</sup> that has met the required holding period

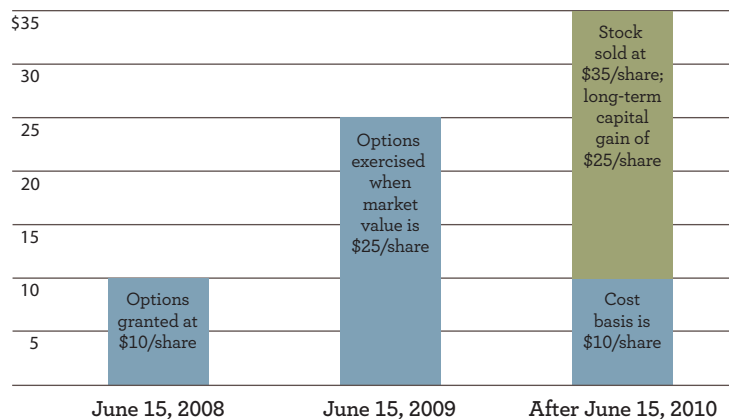
Grant date:	June 15, 2008
Number of options:	1,000
Grant price:	\$10
Stock price at exercise:	\$25

### At exercise (June 15, 2009)

Payment to company:	1,000 x \$10 = \$10,000
Shares to optionee:	1,000
Cost basis:	\$10 per share
Taxable spread:	(\$25 - \$10) = \$15 <sup>2</sup>

### Upon sale of shares occurring on or after June 16, 2010

Selling price:	\$35
Cost basis:	\$10
Long-term capital gain:	\$25 <sup>3</sup>



## Typical tax treatment of the same ISO<sup>1</sup> in a disqualifying disposition

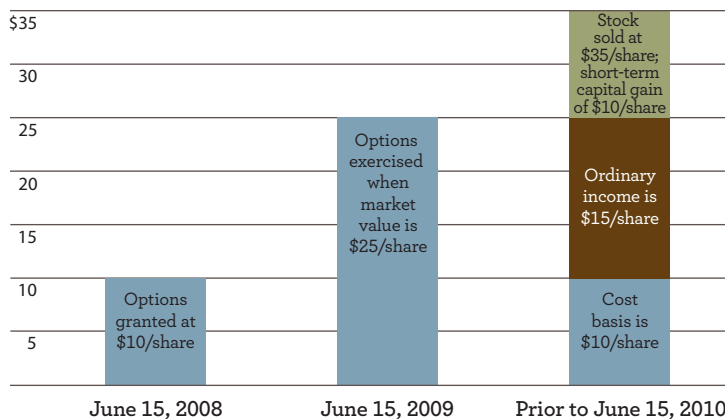
Grant date:	June 15, 2008
Number of options:	1,000
Grant price:	\$10
Stock price at exercise:	\$25

### At exercise (June 15, 2009)

Payment to company:	1,000 x \$10 = \$10,000
Shares to optionee:	1,000
Cost basis:	\$10 per share
Taxable spread:	(\$25 - \$10) = \$15 <sup>2</sup>

### Upon sale of shares occurring on or before June 15, 2010

Selling price:	\$35
Cost basis:	\$25 <sup>4</sup>
Ordinary income:	\$15 per share
Short-term capital gain:	\$10 <sup>5</sup>



<sup>1</sup>These hypothetical examples are designed to illustrate the effects of certain planning strategies based on stated assumptions. The strategies described may or may not be suitable for your particular situation. Before implementing any strategy, you should seek the advice of your tax and legal advisors. No guarantee of specific results is made.

<sup>2</sup>AMT preference item (per share)

<sup>3</sup>Because this sale occurred more than two years after the options were granted and one year and one day after the options were exercised, the holding period requirement was met. Therefore, this transaction qualified for long-term capital gains treatment.

<sup>4</sup>Because both tests for meeting the holding period requirement have not been met, the ISO status is disqualified. When you sell, the stock price at exercise (\$25) becomes the cost basis because you are obligated to pay ordinary income tax based on the taxable spread on the date of exercise (\$15) and you have paid the grant price (\$10).

<sup>5</sup>Because you have not held the shares for at least one year and one day following exercise, the capital gain is a short-term capital gain, currently taxed at marginal tax rates.

is terminated, your ISOs will qualify for long-term capital gains tax treatment for only 90 days following your separation date. After 90 days, your ISOs may expire, or they may be converted to NSO tax treatment. Therefore, you should carefully review the terms in your option agreement and stock plan to determine how the options will be treated if you are terminated, voluntarily separate, retire, become disabled or die.

### NSOs

NSOs are the more common type of options companies grant. As with ISOs, no taxable event is created when NSOs are granted. Unlike ISOs, however, a taxable event occurs when you exercise NSOs. This taxation occurs whether you sell the resulting shares immediately or continue to hold them following exercise.

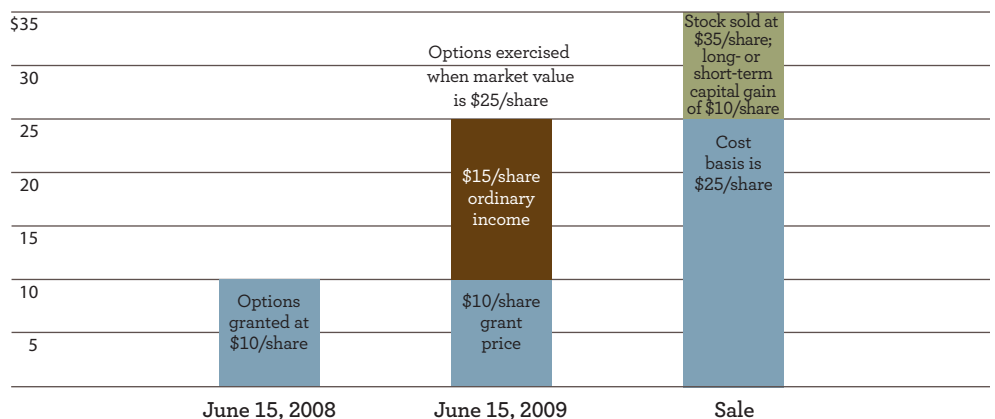
When an NSO is exercised, you must recognize ordinary income equal to the taxable spread (stock price on the date of exercise minus the grant price). This income will be considered compensation income paid to you and will be included on your Form W-2. This compensation will be subject to income taxes as well as FICA (up to the FICA wage base) and FUTA.\* (See “Planning for Withholding Taxes” on page 7.) Once NSOs are exercised, your cost basis for the shares will be equal to the stock price on the exercise date. If you elect to hold the shares following exercise, this cost basis will be critical to computing your future gains or losses when you eventually dispose of the stock.

When you sell the shares, you will recognize a capital gain or loss equal to the difference between your cost basis (stock price at exercise) and the price at which you dispose of the shares. If you sell within one year of the exercise date, the capital gain or loss will be short-term. If you sell the shares more than one year after the exercise date, a long-term capital gain or loss will result.

Using the same facts as our ISO example on page 4 (1,000 options, \$10 grant price, \$25 stock price on the date of exercise), when you exercise your NSOs, you would recognize \$15 per share as ordinary income (\$15,000 total). Depending upon how long you hold the shares following exercise, you would recognize a short-term or long-term capital gain on any selling price in excess of \$25 per share (your cost basis).

\*Federal Unemployment Tax Act

### Typical NSO<sup>†</sup> tax treatment



<sup>†</sup>This hypothetical example is designed to illustrate the effects of certain planning strategies based on stated assumptions. The strategy described may or may not be suitable for your particular situation. Before implementing any strategy, you should seek the advice of your tax and legal advisors. No guarantee of specific results is made.

## Funding your stock option exercise

The simplest way for you to exercise your option is a cash exercise; i.e., you simply write a check to the company for the purchase amount (grant price times the number of options being exercised). However, raising the cash to pay this purchase price can be difficult. In addition, you may owe taxes as a result of your exercise, and this amount may need to be tendered at purchase as well.

If you don't have available cash to fund your option exercises or don't want to use your cash reserves to exercise your options, there are other strategies that may be available, depending upon your situation.

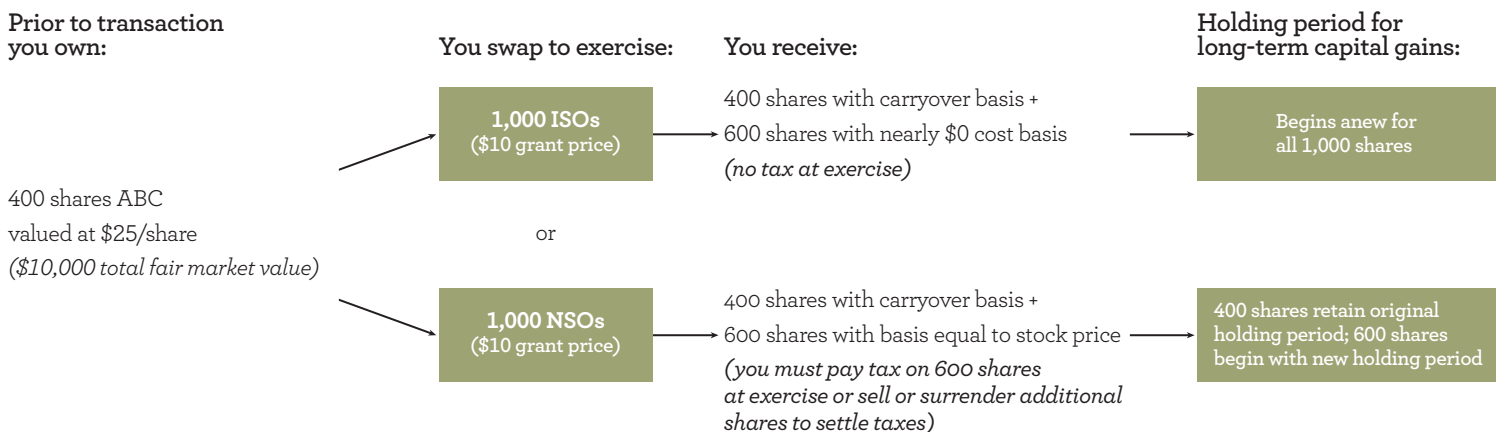
A stock swap is one such method. If your employer's stock option plan contains a stock swap feature and you already own company stock, you may be allowed to trade your existing shares back to the company to pay the grant price for exercisable options. The stock price of the shares you surrender will determine how many options you can exercise.

Assume you own 400 shares of your company's stock and the current stock price is \$25 per share. The total value of these shares equals \$10,000 — the same amount you need to pay to exercise the 1,000 options granted to you at a grant price of \$10 per share. By surrendering your 400 shares, you get back 1,000 shares.

The advantage of a stock swap is that you avoid paying capital gains tax on the shares you surrender. If you then continue to hold the shares that you acquire via the option exercise for the required holding period, you may find that a stock swap is a better alternative than selling your shares outright. In general, it is better to perform a stock swap with ISOs because of the tax treatment afforded to you if you are able to hold the shares for the required term.

If you are swapping shares to exercise ISOs, your holding period will begin anew on all 1,000 shares. If you want to hold the shares to qualify for long-term capital gains tax treatment, you will need to hold the shares for more than one year following the swap date. Any disposition prior to this date will result in a disqualifying disposition (for ISO shares). If you are swapping shares in an NSO exercise, the shares have

### Tax consequences of a stock swap



## Planning for withholding taxes

Your employer will report the ordinary income you must recognize in the year you exercise your NSOs on your Form W-2. As with any other compensation, your employer will generally withhold federal income tax (at the same rate as the taxation on bonus compensation – currently 25%), employment taxes (Social Security and Medicare, which could be as high as 7.65% depending on other compensation paid to you), and any other applicable state or local income tax. Most employers require you to remit any required tax withholding along with the amount you pay to exercise your option. Because this increases the cash you need, you should factor withholding taxes into your cash planning. Be sure to consult your tax advisor before exercising stock options to determine the additional taxes you may owe.

different holding periods. Some of the shares will have a carryover holding period and others will have a holding period that commences after the swap. If you fail to meet the holding period requirements, selling the shares will result in short-term capital gains tax treatment.

The tax consequences of a stock swap can be complex. In our example on page 6, 400 shares that you receive in the swap will retain the same cost basis as the 400 shares that you surrendered to the company. The excess portion, 600 newly acquired shares, will have a nearly \$0 cost basis if you are exercising ISOs, or a cost basis equal to the stock price on the exercise date if you are exercising NSOs.

You should consult your tax advisor before implementing a stock swap strategy. You also must check your company's plan's terms to ensure that the shares you own qualify for this strategy. Companies typically require that you have held the stock for a specified period before it can be used in a swap. You also need to realize that by swapping existing shares for option shares you will end up with fewer shares than if you simply purchase the options outright.

'Cashless' stock option exercises are also very popular. A cashless stock option exercise lets you exercise your options without raising large amounts of cash or disturbing your existing portfolio or cash reserves.

Contact your Financial Advisor, who can help you take advantage of Wells Fargo Advisors' Cashless Stock Option Exercise program. He or she will notify your company of your intent to exercise through Wells Fargo Advisors and verify that your options are available and ready to be exercised.

Using a cashless stock option exercise, you can either sell all of the shares immediately or hold a portion for potential future appreciation. Once you have determined how many shares you want to sell, your Financial Advisor will place a trade to sell your shares in the open market even before the shares are delivered by your company. When the order executes, Wells Fargo Advisors advances the necessary funds to pay the exercise costs and any tax withholdings the company requires. We then work with your company to ensure that the shares are delivered to Wells Fargo Advisors and the net shares or net proceeds will be available to you.

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The freedom from using your own cash reserves is one reason for the popularity of this option strategy. However, there are other benefits as well. Using a cashless exercise strategy will provide the opportunity to target the price at which you desire to exercise and/or sell your shares with a high degree of confidence. Because the sale occurs simultaneously with the exercise, this program gives you the ability to react quickly to changes in the stock's market price. With other exercise methods, several days may elapse between the time you decide to exercise and when you are able to actually purchase your option shares. Your company's stock may reach your target price and fall back below it before you are able to complete the necessary steps to implement your decision to exercise.

A common variation of cashless stock option exercise is a strategy known as "sell to cover." Using this strategy, your Financial Advisor will sell only those shares necessary to fund the exercise costs and taxes associated with exercising the amount of options you want to exercise. You continue to hold the option shares in excess of those needed to pay the costs of the entire exercise. As a result, the exercise is self-funded.

Margin loans may also be available to fund your option exercises. Using this strategy, you borrow the necessary funds from Wells Fargo Advisors to cover the exercise costs and taxes associated with your investments. The shares received from the option exercise are then deposited into your Wells Fargo Advisors account and serve as collateral for the outstanding loan until it is repaid. The amount you can borrow is subject to regulation and is tied to the value of your holdings in the account. Because of the risk, this should not be considered as a long-term strategy.

Regardless of your objective, the Wells Fargo Advisors Stock Option Exercise program can help you maximize the benefits that your employer has granted.

## **Making the most of your stock option benefit**

Because of the varying cash requirements and tax consequences associated with ISOs and NSOs, carefully consider when you should exercise your options and develop an option exercise strategy that works for you. You should include your Financial Advisor with your team of legal and tax advisors to develop an exercise strategy that furthers your overall financial plan.

Combine your knowledge of your company, your Financial Advisor's knowledge of the market conditions and any other factors that can affect your stock's trading patterns. Factor in your tax advisor's evaluation of your tax situation and how exercising your options will affect your current and future tax liabilities. Once you've assessed these relevant factors, you can begin to meet your goals with a well-planned exercise and/or sales strategy.

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## Glossary

**Alternative minimum tax (AMT):** A special tax originally designed to help ensure that wealthy individuals couldn't use certain strategies to avoid paying income taxes. Today, many middle-class taxpayers find themselves subject to the AMT. Exercising ISOs can generate an AMT preference item equal to the difference between the option price and the stock's value on the exercise date.

**Capital gain or loss:** The difference between an employee's cost basis and the stock's market value on the day a security is sold. Capital gains (or losses) are short-term if the employee holds the security for one year or less and long-term if he or she holds the security for more than one year.

**Cashless option exercise:** A method of exercising stock options without requiring the employee to make any initial cash outlay.

**Commission:** The fee a financial institution charges for executing a transaction.

**Cost basis:** For NSOs, the stock's value on the exercise date. For ISOs, the grant price paid when options are exercised (unless disqualified).

**Disqualifying disposition:** The sale or other disposition of shares acquired through an ISO exercise before satisfying the holding requirement.

**Exercise date:** The date stock options are exercised to purchase stock at the grant price.

**Exercise price:** See "Grant Price."

**Grant date:** The date stock options are given to the recipient.

**Grant price:** The price an employee must pay the company for shares purchased when exercising options. The grant price is set on the grant date. Also referred to as the option price, exercise price or strike price.

**Incentive stock option (ISO):** A type of stock option that qualifies for special tax treatment. Exercising an ISO does not create taxable income; however, it may increase the possibility that the employee will be subject to the AMT.

**In-the-money:** A phrase used to describe stock options whenever the market price of the underlying stock rises above the grant price.

**Margin loan:** A loan that lets an individual purchase stock and borrow up to half its market value from a brokerage firm. Using this strategy comes with substantial risk.

**Market price or value:** The current stock price of a public company as determined by the stock market.

**Nonqualified stock option (NSO):** A type of stock option that incurs ordinary income taxes at exercise, regardless of whether the shares are sold or held.

**Option price:** See "Grant Price."

**Out-of-the-money:** A phrase used to describe stock options whenever the market price of the underlying stock is below the grant price.

**Rule 144:** A rule requiring that any sale of company securities by an executive officer, director or other affiliate be reported to the Securities and Exchange Commission (SEC) under the Securities Act of 1933.

## You can count on us

Your Financial Advisor will work with you and your tax advisor to create an exercise strategy for your employer-granted stock options.

**Settlement date:** The date by which either cash (for a buyer) or shares of stock (for a seller) must be delivered to a brokerage firm to complete a securities transaction.

**Spread:** The difference between the grant price and the stock's value on the exercise date.

**Stock option:** A right a company issues that gives the recipient the ability to purchase a specific number of shares of company stock at a specified price during a specific period.

**Stock option agreement:** A document that sets forth the terms of options issued to employees. It includes the type and number of options granted, vesting schedule, expiration date and funding alternatives.

**Stock option financing:** See "Cashless Option Exercise."

**Stock split:** A strategy a company may use to decrease its stock price to keep it within a desired range. In a two-for-one split, for example, a company would issue additional shares to double the number of outstanding shares. The market would typically respond by initially reducing the value of each share on the market by one-half.

**Stock swap:** A feature that lets an option holder surrender shares of company stock he or she owns to cover the amount owed on the exercise date.

**Strike price:** See "Grant Price."

**Stock symbol:** The unique identification symbol given to a corporation whose stock is traded on a stock exchange or the Nasdaq.

**Underwater options:** See "Out of the Money."

**Vesting:** A schedule requiring that a certain time period elapse after the option is granted before it can be exercised.

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*Specific questions on taxes as they relate to your situation should be directed to your tax advisor.*

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