

## Employee Stock Options

Employers use stock options to compensate, retain, and attract employees. Stock options allow employees to buy shares of the company's stock at a certain price for a given period. This is a way for employees to participate in the company's potential growth, and it helps incentivize their work.

Stock options are issued, or "granted", at a price set by the employer company, called the "strike price". Typically, there is a vesting schedule that must be satisfied before the employee can exercise the options. Vesting is the process of gaining 100% ownership of an asset. This typically happens over time, and every employer has a different vesting schedule.

Once a stock option has been granted and is fully vested, the employees can purchase the shares at the strike price or "exercise the option". Once the options are exercised, the employee has the freedom to either sell the stock immediately or wait before selling the stock option. There are two primary types of stock options: incentive stock options (ISOs) and nonqualified stock options (NQSOs).

Under the Internal Revenue Code, properly structured ISOs are eligible for preferential tax treatment. If an employee is granted an ISO, there is no taxable income upon the grant date. There is also no ordinary income or capital gains tax upon the exercise of an ISO. The shares must be sold at least two years after the ISO grant date and one year after the ISO exercise to receive long-term capital gain tax treatment on any gain made from the sale. This holding period requirement also applies to NQSOs.

NQSOs are generally subject to higher taxes than ISOs because they are taxed on two separate occasions. When you exercise NQSOs and opt to purchase company shares, the difference between the market price of the shares and the strike price is called the "bargain element". The bargain element is taxed as compensation, which means you'll need to pay ordinary income tax on that amount. When company shares are sold, the gain will also be subject to long-term capital gains tax treatment if you meet the holding period requirements.

Stock options can play an important role in your portfolio and provide the opportunity to build significant wealth. Having a clear understanding of what kind of stock options are available to you and how they are taxed is essential to maximize your benefits. Stock options can put you at an advantage for retirement and provide diversity within your portfolio.