

WHAT YOU NEED TO KNOW ABOUT STOCK OPTIONS

by
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Stock Options are a benefit given to employees of privately held and publicly traded companies as a form of compensation that goes well beyond a salary and allows the employee to benefit from the success of the company in the future. Start up companies in particular may use stock options to retain more cash by incentivizing the employee to work hard for less of a salary with the goal of them being highly rewarded if it goes public. Along with the upside potential there is risk to be aware of to either party awarded Stock Options in a divorce, especially the non-employee spouse. Understanding the difference in vested and unvested stock options as well as the tax implications of different types of options is imperative before making a decision to keep or acquire them in a Divorce Property Settlement.

Granting Stock Options

The options may be granted to the employee at the employer's discretion and the number of options granted will vary depending on the financial value the company places on the employee or a longer term performance incentive. Each stock option award will have a specific number of shares of stock with a grant or strike price using the value of the stock at or near the grant date, a vesting schedule, and expiration date. These details will be in the Grant Letter. If the employee accepts the terms, he will then execute a Stock Option Agreement. As vesting occurs, the employee may then exercise the vested stock options purchasing shares at the grant price at some point in the future with the goal that the underlying value of the stock is much greater than the strike price thus creating potentially significant profits or wealth for the employee.

In-the-Money and Out-of-the-Money Options

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The difference between the grant price and 'exercise' price is called the *In-the-Money* value of the option or what its intrinsic value is before tax. An example of how a stock option grant and vesting schedule with its In-the-Money value is outlined later. If the stock's grant price is more than the value of the stock then it is *Out-of-the-Money* and has no intrinsic value. If the stock option, for whatever reason, is not exercised before its expiration date it will expire worthless. Because it is difficult to predict how much a stock's price will rise or fall in the future, it is human nature to want to hold onto the option until expiration to see how far up it can go, however, as recent times have clearly shown, what goes up may just as quickly go down. Therefore, holding onto an option until expiration is not a wise stock option exercise strategy. A stock option analyzer is a more sophisticated method of modeling options to determine the amount of leverage each batch has and the ideal time to exercise based on risk tolerance and time horizon. A stock that is \$10 may go up \$2 per share or 20% in price, however if the grant price is \$5, the difference in \$10 and \$12 is 40% ($\$12 - \$5 = \$7/\text{share}$ and $\$10 - \$5 = \$5/\text{share}$; $\$7/\$5 = 40\%$) in option world.

Qualified and Non-Qualified Stock Options:

When a *Non-Qualified Stock Option* is exercised, the difference between the grant and exercise or 'strike' price is taxed at ordinary income. This is the most common type of option. The less prevalent Qualified Stock Option or *Incentive Stock Option "ISO"* has preferential tax treatment if specific holding period requirements are met by IRS rules based on date of issue and date of sale of the stock. If the ISO qualifications are met, then capital gains rates apply to the option, which is advantageous to the employee since in most instances capital gains rates are much lower than ordinary income tax.

Vested and Unvested Unexercised Stock Option

Risk: Unvested or vested and unexercised stock options may be lost in their entirety in the event there is a change in employment status due to termination, retirement or death. The Stock Option Agreement may state that after one of the aforementioned events that the employee has anywhere from zero days until the expiration day to exercise the vested or unvested options. Stock options are rarely transferable to another party except in the case of a beneficiary assignment at death.

Stock options in Divorce: In addition to risk associated with the stock market with a publicly traded company, a soon to be ex-spouse has a myriad of risk factors if awarded stock options in a divorce. Because the stock option is given to the employee as compensation, the company is not interested in allowing the options to be transferred to a former spouse in a divorce. The employee becomes Constructive Trustee of the Stock Options awarded to the non-employee stock in the divorce. As Constructive Trustee, the employee spouse will execute orders to exercise the stock options on behalf of the non-employee spouse and deliver shares or funds (net of taxes) to them within a specified period of time. A specific order should be entered addressing issues related specifically to the property award:

- Methods of communication acceptable to receive instructions to exercise an option
- Timeframe the employee must execute the transaction after receipt of instructions
- Timeframe for delivery of shares or funds

- Unexercised options upon death of employee or non-employee ex-spouse
- Federal Income and Social Security tax of the option

Only a percentage of the unvested option's In-the-Money value will qualify as *community property* in a divorce. If the stock options were acquired during marriage, the separate property interest is determined by using the number of days from the date of divorce until earliest vesting date and the period of time from when the options were granted until they can be exercised.

As with any asset, to analyze all factors involved in the client's situation, stock options and other executive benefits may have more moving parts than meet the eye. Therefore, an evaluation of the client's need for liquidity, personal risk profile, tax bracket, type of options granted, and a stock option analysis are an immense tool to help determine which party is better matched to bear the risk and to be awarded the asset. Bear in mind, the upside potential of stock options is enticing if the factors discussed fall into play appropriately for your client.

XYZ
Executive Stock Option Incentive Plan
August 31, 2009

Stock Price: \$57.26

Grant Date	Exercise/Exp. Date	Options Granted	Vested Quantity	Non-Vested Quantity	Stock Price	Grant Price	Value Per Share	In-the-Money Value	After-tax At 30%*
02/01/1998	01/31/2011	1,440	1,440	-	\$57.26	\$43.50	\$13.76	19,814	\$13,583
02/01/1999	01/31/2012	1,324	1,324	-	\$57.26	\$50.00	\$7.26	9,612	\$6,589
02/01/2000	01/31/2013	3,229	3,229	-	\$57.26	\$39.75	\$17.51	56,540	\$38,758
02/01/2001	01/31/2011	9,154	9,154	-	\$57.26	\$43.50	\$13.76	125,959	\$86,345
02/0120/02	01/31/2012	8,364	8,364	-	\$57.26	\$59.00	\$ -	-	\$ -
02/01/2003	01/31/2013	11,049	11,049	-	\$57.26	\$39.75	\$17.51	193,468	\$132,622
02/01/2004	01/31/2014	7,619	7,619	-	\$57.26	\$47.25	\$10.01	76,266	\$52,280
02/01/2005	01/31/2015	6,697	6,697	-	\$57.26	\$62.00	\$ -	-	\$ -
								\$ 481,660	\$ 330,178

*Federal Income tax rate of 30% and 1.45% medicare tax are deducted from the In-the Money Value to give After-Tax Value