

STOCK OPTIONS + GRANTS

THE EXECUTIVE'S GUIDE
TO EQUITY COMPENSATION



P E T E R R . W H E E L E R
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Formally published as **An Executive's Guide: Incentive and Nonqualified Stock Options**

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ADVISORPRESS

“Excellent reading for the Chief Executive and all other employees with equity compensation.” **Pat Hyndman**, *Past President and CEO of TEC, an International Organization of CEOs.*

“Great help for any executive seeking guidance on what to do with stock options.” **John M. Eade**, *President of Argus Research Corporation.*

“A must-read book for all financial professionals who need to know the basics as well as the complexities of equity compensation.” **Marv Tuttle**, *CAE, Executive Director, FPA.*

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Foreword

Several years ago our firm was approached by a new client who had a substantial number of stock options issued by his company. He needed our guidance on how and when to exercise his options. He planned on selling some stock after exercising his options in order to diversify his portfolio and then give us the money to invest. While his situation was a bit more complex than most, it was not unique and we did not anticipate any great problems with his request.

As I set out to learn about the various issues affecting our client and to develop a plan to mitigate the tax consequences and other issues surrounding his

situation, I was amazed to find that there was very little information available for executives or their advisors regarding stock options. I also found that there was no effective tool to analyze the effects of exercising options. The questions to answer were numerous:

Which options do I exercise?

When do I exercise them?

Do I hold them once I exercise?

When should I sell?

What are the tax consequences of my decisions?

At the time we had to design our own spread sheet to handle these questions. Since then, several commercial products have become available to help professionals and executives analyze their stock option choices. These programs vary in their usefulness, however, all require that the user has some prior knowledge of stock options.

The first edition of this book was published in December, 2000. At that time we were just beginning to see the impact of the dot com collapse. For the next three years, we had to deal more with what to do with “underwater” options and lost fortunes than with tax planning for gains on exercised options. During that time, interest in stock options substantially waned. Many employers reported that prospective employees didn’t want stock options as part of their benefit package. As the markets started to recover in 2003, Microsoft announced that it would no longer issue stock options to its 55,000 employees.

However, after the market collapse of 2000/2002, millions of unexercised options remain and even those that are now underwater may return to value. As the stock market improves, there is a renewed interest in options as a valuable part of an overall benefit package. As the Enron debacle forces changes both to the laws

governing the granting and taxation of stock options and to the way companies use stock options as employee incentive compensation, we may well see the stock option regain its rightful place, encouraging ownership and employee interest.



Introduction

The Importance of Stock Grants

Stock grants are not new. For years they have been used as a perk for senior management. What is new, however, is the extent to which stock grants are now a major part of the compensation package and wealth of the average worker. A study by The Federal Reserve Board found that 37% of companies offering stock options have broadened them to include many nonexempt employees. Another study by Oppenheimer Funds in 1999 found that 10% of private sector employees held stock options. That would be about 12 million American workers. The National Center for Employee Stock

Ownership in Oakland, California, estimates that 10 million non-management employees held nonqualified stock options (NQSOs) at the end of 2000. This compares to just one million at the end of 1992. A tenfold increase in just eight years! The National Center's study found that 74% of the responding companies granted options to non-management employees. Oppenheimer estimated that 50% of all public companies offered stock options to all employees. A study by Option Wealth, Inc., of Rockville, MD, put option ownership at 14.1 million workers holding \$522 billion of option value. Since then, of course, we have had the collapse of the dot coms and the market collapse of 2000/2002. While it is reasonable to assume that there has been a drop in the number of option holders and the value of their options, it seems no one has been particularly interested in updating these studies. We do know that from 1998 to 2002, S&P 500 companies granted options valued at \$157 billion. However, the value of options granted in 2002 was more than 40% below that of 2001. Was this a reflection of fewer options being granted, lower stock prices, or a combination? Whatever the cause, in spite of the market correction new plans are still being implemented at a high rate.

“Many people today probably take more time reading the nutritional information on a jar of spaghetti sauce than they take reading their option agreements.”

Marci Rossell, Chief Economist, Oppenheimer Funds

The Oppenheimer study also found, at that time, that employees viewed stock options as a major factor in deciding to accept a job. While the market collapse has had an impact, stock options remain a significant part of a well designed

compensation program. However, the Oppenheimer study found that many employees knew more about Einstein's Theory of Relativity than they did about their stock options. The study painted a graphic picture of just how little is known about stock options by the employees who hope to benefit from them. Without education, many companies are wasting the benefits they had hoped to achieve with their stock option plans.

The Oppenheimer study also found that:

- 74% said they know very little about their stock options.
- 52% didn't know the tax consequences of exercising their options.
- 50% think their company's stock will do better than the market.
- 34% didn't know if they had ISOs or NQSOs.
- 75% didn't know about the Alternative Minimum Tax (AMT).
- 11% had let their options expire "in-the-money."

When Oppenheimer asked the respondents what kind of options they had, no one was able to respond. However, when asked if they had incentive stock options or nonqualified stock options, 30% were able to respond.

In spite of the 2000/2002 market collapse, stock grants have generated tremendous wealth. According to iQuantic, a San Francisco consulting firm, options generated more than \$500 billion of wealth in 1999 alone. However, iQuantic's annual study of technology companies found that the median value of a stock option grant was only \$20,000 to \$30,000. While more than 160,000 high-tech company employees became millionaires in 1999; clearly, many option holders will not become overnight millionaires. Even the smallest option holder will face many of the same questions about tax consequences and option exercise strategies that CEOs have faced for years.

Average Value of Grant by Job Category

	Value of Grant [\$]
Executives	511,804
Senior Managers	139,375
Middle Managers	57,208
Salaried Technical	35,481
Salaried Nontechnical	22,708
Sales	51,762
Hourly	7,982

Unfortunately, this sudden explosion of stock option holders caught the advisory community by surprise. Many accountants, attorneys, financial planners, and stock brokers know little more about stock options than their clients. Additionally, there has been very little in print that either advisors or option holders could turn to for guidance. While the void is beginning to fill, much of the information is too technical for the lay person.

Many of the questions I had to find answers to as I started to work with our stock option clients are answered in this book. I have made every attempt to keep the answers understandable. This is a very complex area of the law and I don't want you to be among the 52% who don't know the tax consequences of your options. However, I don't anticipate that this book will make you an expert either. Because state laws vary greatly, this book does not address them. Use this book as a guide to help in your understanding of this very valuable asset that your employer has provided you. Make sure that you have a qualified advisor working with you to insure that you maximize the value of your assets.

Since these studies were completed, we have seen the demise of most of the dot com companies, the collapse of Enron and Global Crossing and substantial stock price drops in industry giants such as Lucent Technologies, Cisco Systems, and Qualcomm. Even non-technology stalwarts such as Home Depot and Wal-Mart lost market value during the 2000/2002 market collapse. As a result, stock options lost some of their charm. But, as markets recover, so does the interest in stock grants. Many stock options that were underwater are back in the money and more will be as the market recovery continues.

We believe that tying the program to performance is important to creating shareholder value.

Steve Ballmer, CEO, Microsoft

As noted in the Oppenheimer Study, most employees, in the late 1990s, believed that their company's stock would grow faster than the market as a whole. Through the late 1990s that may have been the case. In just three years, much of that excess growth had been eliminated, leaving many stock option holders devastated, and many financial advisors feeling that they had preached the need for diversification to a disinterested congregation. Between their 401K plans, pension plans, and stock options, employees from the boardroom to the mail room had 60 to 80% of their worth tied up in the same company that they depended on for their income, health insurance, and long-term security. When the company collapsed, all was lost. Maybe now, before the next big sell-off, employees will take to heart the Core Capital™ concept discussed later in this book.

**Percent of 401K Plan Held in Company Stock
as of December 1999**

Company	Percent
Proctor & Gamble	95
Pfizer	86
Coca Cola	82
GE	77
Texas Instruments	76
McDonalds	74
Enron	62
Ford	57
Quest	53
AOL/Time Warner	52



CHAPTER 1

What Are Stock Grants?

What is a Stock Option?

Generally, a stock option is a right granted to the holder of the option to be able to purchase a certain number of shares of a stock at a stated price within a given time period. There is no requirement to exercise the option even if the stated price is reached.

There are two main types of stock options: exchange traded stock options and employer grant options. **Exchange traded stock options** are stock options that trade on the various stock exchanges and may be bought and sold in much the same

fashion that the stocks themselves are. **Employer grant options** are rights granted by employers to employees as part of compensation packages.

All options have a **strike price**, an **expiry date**, and a stated number of shares to which the option applies.

The **strike price** is the price at which the option can be exercised or purchased, regardless of its market price.

What are Exchange Traded Options?

Exchange traded stock options are sold (written) by investors who hope to make money on the swings in the stock's price. A **call option** grants the holder (buyer) the right to buy the stock away from the seller (writer) of the call. A **put option** grants the buyer the right to sell the stock at the strike price. Both are at a stated price (the **strike price**) above or below the price of the stock on the date the option is written and are exercisable on or before a specific date (the **expiration date**). A **covered option** means the writer of the option owns the stock. A **naked option** means that the writer of the option does not currently own the stock upon which the option is written. Once written, these options are often traded and take on a value of their own depending on the market price of the stock versus the option strike price and the time remaining to the option's expiry date.

Options will either: 1) Expire unexercised on the expiration date, 2) Be exercised, or 3) Be sold before they expire. As you pay for options (the **premium**), you will have a short or long-term capital gain or loss on the exercise or expiration of the option. This is not the case with employer grant options. The option writer also has tax consequences upon the exercise or expiration of an option. See **Chapter 14**.

What are Employer Grant Options?

Employer grant options were once reserved for the narrow ranks of senior executives. Today, many firms include middle management and other employees in their stock option plans. As a result, many employees find themselves with substantial potential wealth tied up in their employer's stock option plan.

Employer grant options are intended to provide employees with a vested interest in making the company profitable. To the extent that the company's successes are reflected in the growth of the company's stock price, then the employee will share in those gains through stock options. Employer grant options are restricted and are only available to the company's employees, members of the board, and consultants.

Generally, all employer grants are referred to as **compensatory stock options** because they are a part of the company's compensation plan. They are also known as **incentive stock options** because of their incentive-based purpose. There are actually five types of employer grant stock options: **stock appreciation rights, phantom stock, stock awards, incentive stock options, and nonqualified stock options**. There are also employee stock purchase plans.

What are Stock Appreciation Rights and Phantom Stock?

Stock appreciation rights (SARs) and **phantom stock** are really pseudo-options. While employee incentives, they are not actually stock options. These pseudo-options do not actually offer ownership in the company. Rather, they offer a conditional bonus based on the future performance of the company. Most often these plans are offered by non-public companies where the value of the company's stock is not determined by open market trading. However, Microsoft, perhaps the largest issuer of stock options, maintains a companion SAR plan as well. See **Example 1.1**.

Example 1.1 Jones Company, Inc., a closely held corporation, has only one shareholder, Mr. Jones. Mr. Jones doesn't want to share ownership with his employees, but does want them to take a vested interest in growing his business. Mr. Jones develops a formula to fairly determine the current value of the business. He then develops a SAR that provides that his three key managers will share in the growth of the business above the current value based upon some triggering event, such as his retirement.

A variation on this is the **Junior Stock Plan**. Your employer issues you "junior" non-voting common stock of the company. The shares may be dividend paying or non-participating. At a future date, the shares may be converted to the company's common stock subject to your meeting certain conditions. Continued employment would be the most common. You pay for the junior shares (like paying for an option). Any discount from the FMV is ordinary income, so your basis is the FMV of the company's stock. There is no tax consequence when the junior shares are converted. When you subsequently sell the common shares, your basis is the FMV at the time of purchase of the junior shares.

The variations of SARs are unlimited. There are no tax benefits to such plans and no statutory requirements. For the benefit of the employer and participating employees, they should be carefully thought out and presented in writing. I would strongly recommend that a qualified attorney draft the document. This book does not address SARs and phantom stock options.

What are Nonqualified Stock Options?

Nonqualified stock option (NQSO) plans are the most popular plans. In spite of the less desirable tax consequences, they offer substantially greater flexibility than incentive stock options, thereby increasing their popularity. There is no limit on the dollar amount or number of shares that may be granted to an employee. NQSO grants may also be made to owners of more than 10% of the stock who are employees, board members, or consultants. Taxation at exercise is the same as on your regular compensation as an employee. See **Chapter 3**.

What is an Incentive Stock Option?

Incentive stock options (ISO) are also known as **statutory stock options** because they are subject to a strict set of statutory regulations and are only available to employees. As a result, they also offer significantly better tax benefits than nonqualified stock options. Since all options are granted to create an incentive, they are often all referred to as incentive stock options. It is important to determine which type of option is actually involved because the benefits and restrictions will differ. See **Chapter 4**.

What are Stock Awards?

Stock awards are direct grants of the employer's stock to the employees. They may be subject to vesting requirements prior to the employee actually receiving the stock-like stock options. However, once vested, the employee receives the actual shares of stock not a right to purchase the shares. See **Chapter 5**.

What is an Employee Stock Purchase Plan?

Employee Stock Purchase Plans (ESPP) are also statutory stock plans and are subject to a strict set of statutory regulations. They are often referred

to as “Section 423 plans” as they are governed by IRC Section 423. Under an ESPP, employees use after-tax payroll deductions to purchase company stock at a discount of usually 15%. Surveys have shown that 75% or more of the companies offering ESPPs offer Section 423 plans. However, about 25% offer a nonqualified ESPP. These plans are known as “open market purchase plans” and do not offer the tax benefits of a Section 423 plan. It is important to know which plan you have. See **Chapter 6**.

A Comparison of ISOs and NQSOs

Feature	ISOs	NQSOs
Tax - date of grant	No tax impact	No tax impact
Tax - date of exercise	FMV - EC = Preference item for AMT on Form 6251	FMV - EC = Ordinary Income on Form 1040
Tax - date of sale if held for one year	FMV - basis = Capital Gain (basis = EC + offset for AMT if applies)	FMV - basis = Capital Gain (basis = EC + Ordinary Income at execution)
# options issued	\$ limit	Unlimited
\$ limit on options issued	\$100,000	None
Alternative Min. Tax	Subject to	Not subject to
Ordinary income tax	No	Yes
Withholding, FICA, Med.	No	Yes
Capital Gains	Yes	Yes
Deductible to Corporation	No	Yes
Transferable	No	Yes

FMV = Fair market value

EC = Exercise cost

AMT = Alternative Minimum Tax



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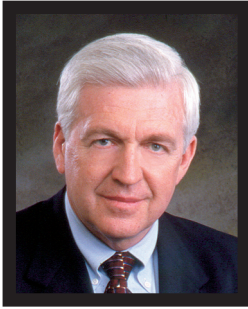
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“A must-read book for all financial professionals who need to know the basics as well as the complexities of equity compensation.”

Marv Tuttle, CAE,
Executive Director, FPA.

Peter R. Wheeler, CLU, ChFC, CFP, CIMC has over 36 years of experience in the financial services industry. He is the CEO and founder of Wheeler/Frost Associates, Inc., a Registered Investment Adviser, and of FamilyOfficeNetwork, LLC, an Internet based family office providing comprehensive financial advice to high net worth families through independent advisers.

Stock Options + Grants: The Executive's Guide to Equity Compensation provides a comprehensive, easy reading treatment to the complex area of stock options and grants for the busy executive. From the boardroom to the mailroom, individuals with stock options or grants will benefit from the quick reading question and answer format of this book. If you have a question about your stock options or grants, you are likely to find it answered in **Stock Options + Grants: The Executive's Guide to Equity Compensation**.

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