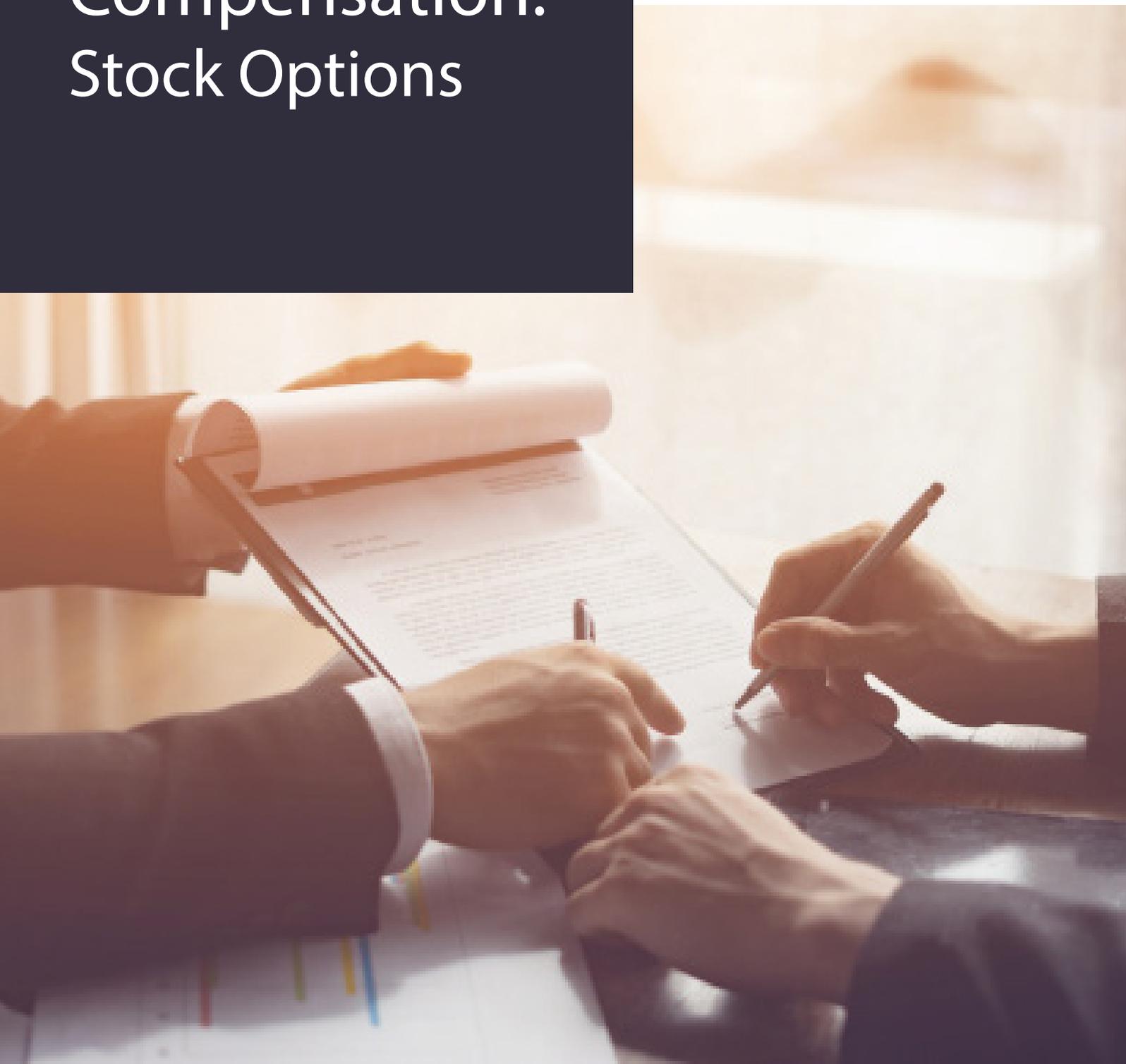

Employee Compensation: Stock Options



Stock option plans offer employers tax benefits and a way to attract and retain key employees. They tie compensation to your company's success and motivate employees to stay with your company longer.

What are Stock Options?

With a stock option plan, the company grants employees the "option" to buy a specific amount of stock in the company, at a specific price, within a specific period of time. For example, John Smith may be granted the option to purchase 100 shares at \$2 per share and the option might expire in 10 years.

The price at which John is able to purchase a share of stock is called the exercise price or strike price. This price is typically the fair market price of the stock at the time in which the option is granted to the employee. Privately held companies often rely on their accounting firm to perform a 409A valuation to determine an appropriate exercise price.

In order for the employee to actually exercise the option to buy stock, the option must be vested. Option grants typically include a vesting schedule which shows how many options vest on which dates in the future. For example, John Smith's options may vest over a four-year period at a rate of 25% per year. In this case, the vesting schedule provides John Smith with an incentive to continue working for the company for at least four years.

Even though an employee may have vested options, they typically won't actually exercise those options right away. They will hold the vested options until they have an opportunity to sell the stock for a profit. In a privately held company, the employee will typically wait until the company has some sort of liquidity event so they can both purchase and sell the stock on the same day. This way the employee doesn't have to outlay a large sum of cash to reap the benefits of the options. With that said, there are often tax incentives to not flip the stock and hold the stock for a longer period of time.

With stock option plans, you can decide who is granted options, how many options they are granted and when they are granted. So, you can use options very selectively, to hire and retain top talent in your firm.



Four Types of Stock Options

There are four popular types of employee stock options: incentive stock options (ISO), employee stock purchase plan options, nonqualified options, and phantom stock plans.

Incentive Stock Options

With ISOs, your employees will be offered a specific number of shares they can purchase on a specified date (once they are vested). The shares can be purchased at a price where the stock was valued at the time the option was granted (not when the option is exercised). If your company's stock values increase in the interim between the grant of the option and vesting, your employee gets a great deal.

Your employees will pay no taxes unless they exercise their option, purchase shares, and then resell them. Then, any profits they earn from the transaction are taxed at the capital gains rate (assuming they don't sell the shares for at least 2 years after they purchased the shares). There is no corporate deduction for the employer with ISOs.

Employee Stock Purchase Plans

Employee stock purchase plans usually enable eligible employees to purchase company stocks at 85% of their market value. Many companies allow employees to purchase stock up to a certain value (like 10% of the employee's total pay). The cost of the stocks can simply be deducted from an employee's pay, potentially reducing the employer's payroll tax liability.

Nonqualified Options

Like ISOs, nonqualified options enable you to offer employees a specific number of shares once they are vested. With nonqualified plans, employees will have to pay income tax on any gains they make upon purchase. As the employer, you can take a corporate deduction on any profits your employees realize from nonqualified options. For instance, if stock is valued at \$20 when the option is granted and goes up to \$30 when the option is exercised, the company can deduct the \$10 difference for each applicable share. If an employee keeps the stock and it increases in value, they will only owe capital gains taxes on any profits realized after sale.

Phantom Stock Plans

Phantom stock plans are a little-known option that may be more attractive to smaller or private companies. Phantom stock plans give the employee the benefits of stock ownership without having to actually own the stock. Some phantom stock plans only pay out appreciation of the stock whereas other plans payout the value of the underlying stock plus appreciation.

The company will issue shares to employees at a set price based on the company's current value. Then, you'll specify a future date for re-evaluation of stock. If the stock values increase and an employee elects to sell, the employee will benefit from the profit. You'll distribute the profit to your employees as wages, and they will have to pay taxes on the profit. However, your company will be able to take a corporate tax deduction as well.

Next Steps

As you can see, there are plenty of non-traditional compensation options to help your company retain valuable employees. However, deciding which tool will work best for your company can be complex. Consult with a qualified tax professional to determine the best option for your company.



About Your Firm LLC

We have hand-picked a team with tax, auditing, accounting, business and management advisory expertise in a multitude of fields, including healthcare, professional-services firms, commercial contractors, home builders, real estate companies, manufacturing and distribution companies, dealerships, non-profit organizations and pension funds.

We have the expertise and the resources to provide not only the critical services you need during these evolving economic times, but also, importantly, to build for the future. Our strategic alliances with professional organizations across the country allow us to bring our clients the talent and expertise of national firms with the high-touch service of a local firm. While we remain focused on the core services of tax, accounting and audit, we expand and offer you the business consulting needed to remain competitive. We believe the success of our clients is the greatest measure of our own.



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