Employee stock options and restricted stock units

Wealth Management

Many companies offer employee stock options and/or restricted stock units as a form of compensation to attract and retain employees. Through issuing employee stock options, the employer grants the employee the right to purchase stock at a specified price in the future. Through issuing restricted stock units, the employer grants the right to stock or cash on the vesting date.

When you receive your employee stock options, a predetermined grant exercise price, vesting dates and expiration dates are set.

The price is usually the same as the current market value on the grant date. After the employee stock option has vested, you may exercise your stock purchase option. You pay the predetermined exercise price for the stock, regardless of the current market value.

The key dates in the life of an option:

- **Grant date** — the date the option is granted to the employee.
- **Vesting date** — the date the option vests.
- **Exercise date** — the date the employee exercises the option and purchases the stock.
- **Sale date** — the date the employee sells the stock.

There are two basic types of employee stock options, Nonqualified Stock Options (NQSOs) and Incentive Stock Options (ISOs). The main distinction between an NQSO and an ISO occurs at the exercise of the employee stock option.

A restricted stock unit (RSU) is a form of compensation issued by an employer to an employee in the form of company shares. Restricted stock units are issued to an employee through a vesting plan and distribution schedule after achieving required performance milestones or upon remaining with their employer for a particular length of time.

RSUs give an employee interest in company stock but they do not own the stock until vesting is complete. As shares vest, the fair market value of the vested portion of the grant is considered ordinary income. A portion of the shares may be withheld to pay income taxes while the employee receives the remaining shares to hold or sell at their discretion. The basis of the stock shares received for future sales is the fair market value (FMV) price on vesting date.

Event	Nonqualified stock options (NQSO)	Incentive stock options (ISO)	Restricted Stock Units (RSU)
Grant	Grant exercise price $10/share	Grant exercise price $10/share	No cost to exercise
	No tax consequences	No tax consequences	No tax consequences
Vesting			Market price $40/share
	No tax consequences	No tax consequences	Ordinary income is the FMV on day of vesting. $40/share is subject to ordinary income tax.

Event	Nonqualified stock options (NQSO)	Incentive stock options (ISO)	Restricted Stock Units (RSU)
Exercise	Fair market value $50/share	Fair market value $50/share	
Ordinary income tax	Ordinary income is the difference between fair market value and exercise price. $40/share is subject to ordinary income tax.	None	N/A
Alternative Minimum Tax (AMT) preference	None	AMT adjustment for difference between fair market value and exercise price. $40/share is AMT preference adjustment. **This may or may not cause an AMT amount due.**	N/A
Withholding	Subject to federal statutory withholding (currently 25%), state statutory withholding, FICA withholding (6.2%) and Medicare withholding (1.45%).	Not subject to withholding unless transaction is a disqualifying disposition and then subject to the same withholding as NQSOs.	Subject to federal statutory withholding (currently 25%), state statutory withholding, FICA withholding (6.2%) and Medicare withholding (1.45%).
Fair market value $100/share	Fair market value $100/share	Fair market value $100/share	Fair market value $100/share
Capital gain	If held more than one year, the amount is a long-term capital gain taxed at capital gain tax rates. $50/share is subject to long-term capital gain tax.	If held more than one year, the amount is a long-term capital gain taxed at long-term capital gain tax rates. $90/share is subject to capital gain tax.	If held more than one year, the amount is a long-term capital gain taxed at capital gain tax rates. $60/share is subject to long-term capital gain tax.
	If held less than one year, the amount is a short-term capital gain taxed at ordinary income tax rates. $50/share is subject to short-term capital gain.		If held less than one year, the amount is a short-term capital gain taxed at ordinary income tax rates. $60/share is subject to short-term capital gain.
Disqualifying disposition if holding periods not met		If held less than one year, a disqualifying disposition occurs. If stock is sold within one year of exercise or two years of grant, it is a disqualifying disposition. The difference between the grant price and fair market value on the date exercised is classified as ordinary income.	
Transfer			
	Refer to employer's plan. Generally can be transferred during your lifetime to family members, trust for your benefit or charities.	Can be transferred only at death.	Cannot be transferred.
	Gift is complete only when the employee stock option is vested.		
Lifetime gift			
	Donor subject to income tax on the exercise	Not allowed	Cannot be transferred.
Estate			
	If transferred at death, considered Income in Respect of Decedent (IRD).	If transferred at death, considered IRD Beneficiary is subject to income tax on the gain.	If transferred at death, considered Income in Respect of Decedent (IRD).
	Beneficiary is subject to income tax on the gain.		Beneficiary is subject to income tax on the gain.

Transfers during life: Gift and estate tax consequences

NQSOs can be transferred during your lifetime to family members, trusts for your benefit, or charities, provided the employer's plan allows for such transfers. A gift of NQSOs is complete only when the employee stock option is vested. Giving vested and unexercised NQSOs with strong appreciation potential may avoid future appreciation in your estate.

Further, you, not the donee, will owe the income tax on exercise. This may be desirable because the income tax paid is not treated as an additional gift. ISOs and RSUs can only be transferred at death.

Transfers at death

At death, any gain of NQSOs, ISOs and RSUs are included in the decedent's gross estate for estate tax purposes and is considered Income in Respect of a Decedent (IRD). IRD causes the gain to be included in the beneficiary's gross income for income tax purposes.

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