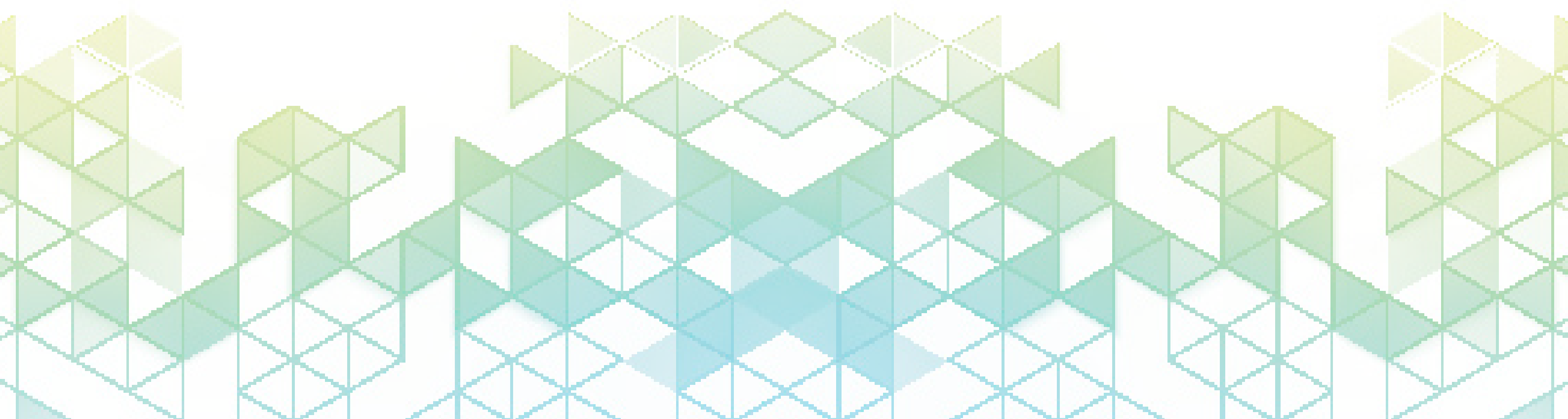
Vasquez & Company LLP

Certified Public Accountants and Business Consultants

Overview and Benefits of a Stock Option Plan



A stock option plan can be an excellent way for employers to align the interests of employees and shareholders and help companies attract and retain talented workers. This document covers the basics of a stock option plan and how your company may benefit from having one.

What is an employee stock option?

An employee stock option is a type of equity compensation that enables the holder to purchase a certain number of shares in a company at a specific price, known as the strike or exercise price, within a predetermined period. For example, Jane may be granted 1,000 options at a strike price of $2.00 with an expiration of 10 years from the grant date.

Companies often set a vesting schedule requiring the holder to wait for a specific period before they can exercise the option. For example, a company may grant 1,000 options to an employee but set a schedule where 25% of the options vest each year over four years so long as the company still employs the recipient. Companies use vesting schedules to incentive employees to remain at the company.

What are the benefits of offering stock options?

Stock options provide employees with upside compensation based on the performance and future value of the company. It also provides employees with a form of ownership that brings them closer to the company.

For employers, stock options enable a company to better align the employees with the shareholders by tying compensation to overall company performance and valuation. Stock options are also valuable in attracting and retaining employees by offering greater potential compensation. And, since stock options don't require a cash outlay, it's an effective tool for start-ups or other cash-constrained companies.

Different types of stock options

Companies can offer two primary types of stock options: incentive stock options and nonqualified stock options.

Incentive stock options can only be granted to employees. The employee will owe taxes on the profits after exercising their option and then selling the stock. The gain is taxed as ordinary income if the employee holds the stock for less than a year. However, it's taxed as a capital gain if the employee holds the stock for at least a year.

Nonqualified stock options, on the other hand, are not restricted to just employees. They can be awarded to individuals outside the organization, such as consultants or contractors.

There are two taxable events with nonqualified stock options. When a stock option is exercised, the participant is taxed at the ordinary income rate on the difference between the stock's current market value and the strike price. When the shares are sold, the participant is taxed on the difference between the sale price and market value price when they exercised the option. If the shares are held for less than one year, then the gain is taxed as ordinary income; otherwise, the gain is taxed as a capital gain.

Employees may favor incentive stock options since taxes are not paid until the stock is sold. Companies may prefer nonqualified stock options because they provide greater flexibility, and the cost of granting the stock options is tax deductible.

Stock option plan and pool

A company will need to develop a stock option plan which dictates how the options will work and authorize shares of stock for the option pool.

The plan document will cover, among other things, how the plan is administered, who is eligible for options, what type of options are available, how they are granted, how vesting works, how options are exercised, what happens in the event of employment termination or a company sale, and the rights of the participants.

In conjunction with the plan, the company will typically authorize a certain number of new shares of stock for the option pool. So a company with 1,000 existing shares may authorize 200 new shares to be used for the stock option pool. In this example, the company ends with 1,200 total authorized shares, of which 16.7% is reserved for the stock option pool.

The company's board or a committee will typically authorize the granting of stock options to an individual. The company isn't obligated to grant any options at all. So even though a company may have authorized 200 new shares for the option pool, it doesn't mean they will all be awarded.

Conclusion

While a stock option plan can be an effective tool for many companies, some business owners are reluctant to give up stock or add new shareholders. For these situations, alternative strategies, such as creating a phantom stock plan, provide many of the benefits of a stock option plan without giving up actual shares of stock.

Final Thoughts

This document provides a brief overview of a stock option plan and is not a substitute for speaking with one of our expert advisors. If you're considering a stock option plan for your company or would like to discuss other types of profit-sharing plans, please contact our office.

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