

How to Maximize Your Employee Stock Options

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Is your role changing or were you recently promoted? Are stock options part of your new compensation package? If you answered ‘yes,’ this is no surprise. More and more companies are granting employee stock options (ESOs) to rank and file employees within compensation packages. ESOs can be a useful tool to attract, retain and motivate employees by aligning employee compensation with company growth. ESOs can also be a lucrative way for employees to grow wealth over time, however, they can be complex and difficult to understand. Familiarizing yourself with the basic concepts and terminology associated with ESOs is a good starting point.

While each stock option plan has its own rules, they all involve the transfer of an equity interest in a company to an employee in the form of compensation. In some cases, the employee is granted the right to purchase the equity interest. In others, they are simply given the shares upon meeting plan requirements, generally based on length of service.

Key Terms

Grant Date – The date when the employer awards the stock options to the employee.

Grant Price – The price of the underlying security on the date the option is granted. This value determines the cost of compensation to the employer for certain types of options.

Strike Price – The fixed price the employee can buy the stock at on a later date.

Vesting Schedule – The time frame which specifies when options within the grant are eligible to be exercised. Generally, most plans require a waiting period of at least one year before options may be exercised.

Exercise Date – The date the employee purchases the company stock at the grant price.

Expiration Date – The last date on which the options can be exercised. This is a key date to know, as the stock options become worthless after their expiration date. It also is important to understand that most options expire upon termination of service, or shortly thereafter.

Most Common Types of Employee Stock Options

Restricted Stock Units (RSUs) – The employee is granted shares that vest over time, similar to a bonus. The employee is not required to purchase the shares, as they are given based on achievement of time or performance requirements. When the shares are issued, the employee is responsible for paying income tax on the value of the shares received on the date the shares are vested. The employee can sell a portion of the shares to cover the tax

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liability and retain the other shares for future sale. If the employee holds the shares for at least a year after receipt, any growth of the shares is taxed as long-term capital gains when sold.

Non-qualified Stock Options (NQSOs) – The employee is granted the right to purchase shares at a specified price (strike price) based on the vesting schedule. Upon exercising this right, the employee must tender funds to pay for the shares at the strike price. If the price of the stock is higher than the strike price, the employee is responsible for paying ordinary income tax on the difference between the market value and strike price, regardless of whether they retain the shares. If the employee retains the shares for at least one year from the date of exercise, any appreciation above the market value on the exercise date would be taxed as long-term capital gains.

Incentive Stock Options (ISOs) – Similar in structure to NQSOs, ISOs are reserved for employees only, and typically used to retain key managers and/or executives. ISOs have a special tax advantage that makes them very attractive for key employees. As with NQSOs, the employee is required to tender funds to cover the strike price upon exercise. However, if the market value of the stock on the exercise date is higher than the strike price, that differential may not be subject to tax due to ISO's special tax treatment. If shares are held for at least one year after the exercise date and two years after the grant date, gains can be taxed at long-term capital gains rates. Depending on individual circumstances, the exercise of an ISO may trigger AMT liability which could be payable prior to the determination of special tax treatment. All ISOs are subject to a mandatory expiration after ten years. Since the exercise of ISOs involves complex tax rules, it is advisable that employees discuss tax repercussions with their tax professional before, during and after the exercise of the option.

Stock Swaps: Enhancing Flexibility for Option Holders

In some employee stock option plans, participants have the opportunity to use a stock swap as a method for exercising their options. A stock swap allows an employee to exchange shares of their company stock that they already own, often acquired from previous option exercises or RSU grants, instead of having to pay cash to exercise new options.

This has several potential advantages:

- **Preserve Cash Flow:** By using existing shares to cover the exercise price, there's no need to tap into personal funds or liquidate other investments.
- **Tax Deferral Potential:** The tax basis and holding period of the surrendered shares transfer to the new shares received through the option exercise. The unrealized gains in your original shares continue to be deferred until you eventually sell the resulting shares.
- **Strategic Benefit:** For those with significant holdings in their company stock, this technique can streamline the process of consolidating positions without generating immediate capital gains on previously held shares.

However, while stock swaps can provide both liquidity and tax flexibility, they aren't permitted in all company plans and may have distinct tax implications depending on your circumstances. If your plan allows a swap, it's

wise to coordinate with your tax advisor to ensure you're managing both your financial exposure and potential tax liabilities efficiently.

Cashless Hold Strategy for Stock Options

A cashless hold is a method employees can use to exercise their stock options without needing to come up with extra cash out of pocket. Here's how it works: when exercising your options, you sell enough of the shares right away to cover both the purchase price (the strike price) and any related taxes. The proceeds from this sale are used to pay for the shares and tax obligations, and you end up keeping the remaining shares. If there are any fractional shares resulting from the transaction, those may be settled in cash rather than stock.

Here's how it typically works:

- You inform your brokerage or plan administrator that you want to exercise your vested options using the cashless method.
- The broker handles the sale by exercising your options and selling enough shares to cover the total cost (strike price plus any taxes or fees).

Any remaining shares (after costs are covered) or net proceeds are deposited into your account, usually within a few business days.

This approach is especially useful if you want to retain some ownership in your company's stock but would rather not, or cannot, invest additional cash at the time of exercise. It allows for a balance between liquidity and maintaining an equity stake, while simplifying the transaction and sidestepping the need for upfront funds.

83(b) Election: Preparing for Anticipated Future Growth

An 83(b) election is a critical tool for employees who receive stock options that vest over time, especially if you believe your company's stock price is poised for growth. By filing this election with the IRS within 30 days of the stock grant, you choose to pay ordinary income tax on the value of the shares at the time of grant—rather than waiting until the shares vest.

This can be potentially advantageous if the stock's value is relatively low when granted, since future appreciation will be taxed at the more favorable long-term capital gains rates when you ultimately sell the shares (provided holding period requirements are met). Essentially, you trade paying tax early on a lower value for the potential to pay less tax overall when selling appreciated shares in the future.

However, it's important to recognize the risk: if the shares decrease in value or never vest (for example, if you leave the company), you won't get a refund of taxes already paid. The decision to make an 83(b) election should be weighed carefully, ideally in consultation with a tax advisor who can help assess your personal tax situation.

Gifts Non-qualified Stock Options (NQSOs)

Gifts NQSOs can be an effective way to transfer potential future wealth to family members or others, particularly if your employer's plan permits such transfers. However, it's important to understand both the potential benefits and the tax consequences involved before proceeding.

From an estate planning perspective, gifts NQSOs can remove the future appreciation of the options from your taxable estate, potentially reducing estate taxes and shifting value to beneficiaries, who may also benefit from being in a lower tax bracket. This strategy can be especially valuable if you expect the company stock to increase substantially in value over time.

However, the transfer of NQSOs is typically not considered a completed gift until the options have vested and any transfer restrictions are lifted. Until then, you as the donor may remain responsible for any income taxes due on the difference between the strike price and the stock's market value (often referred to as the "bargain element") at the time of exercise.

A few key considerations when contemplating a NQSO gift include:

- **Plan Restrictions:** Not all stock option plans allow for transfers. Review the specific terms of your company's plan to confirm eligibility.
- **Income Tax Liability:** The person making the gift is generally responsible for paying ordinary income tax on the bargain element when the recipient exercises the option.
- **Gift Tax Implications:** If the gift is considered complete upon vesting, it may count against your annual gift tax exclusion or lifetime exemption; consult with a tax advisor to understand the impact on your overall estate and gift tax strategy.
- **Beneficiary Taxation:** The recipient will be subject to any taxes due on further appreciation if they hold the shares after exercise.

Gifts NQSOs can be a forward-thinking way to help loved ones or charitable organizations participate in your company's growth, but, as with all equity compensation strategies, careful planning and professional guidance are recommended to minimize unintended tax liability and maximize the benefit of your generosity.

Monitoring and Responding to Stock Price Movements

Understanding and reacting to changes in your company's stock price is a crucial part of managing employee stock options wisely. The value of your options can fluctuate significantly as the stock price rises or falls, meaning that a proactive approach can make the difference between realizing gains or missing out altogether.

It's important to establish a plan for tracking the stock price, especially as your options vest. Regularly reviewing the share price may allow you to take advantage of favorable market conditions, such as exercising options when

they are “in the money” (i.e., when the current stock price is above your exercise price). Acting before expiration ensures you don’t lose the value of vested options if the stock price dips unexpectedly.

While taxes are always a consideration, letting tax consequences dictate all of your timing might result in missed opportunities. Transferring exercised shares to a brokerage account gives you flexibility to use tools like stop orders, which can help preserve your gains if the stock price turns volatile. Failing to monitor and respond to price changes may mean unrealized profits or, worse, options expiring worthless should the company’s stock decline.

Ultimately, by staying vigilant and having a disciplined strategy for responding to price movements, you can better protect your investment and potentially maximize the benefits of your employee stock options.

Strategic Approaches to Stock Options

Managing employee stock options effectively involves more than simply exercising and holding shares. It’s important to understand the different types of options, such as Incentive Stock Options (ISOs) and Non-Qualified Stock Options (NQSOs), and the distinct tax implications of each before making any decisions. Mistakes can happen, such as selling vested shares too early, failing to protect gains as the stock appreciates, waiting until the last minute to exercise options near expiration, or neglecting to plan for taxes in advance. Each of these missteps can have unintended financial consequences, which is why it is important to seek professional advice.

Key Considerations

One of the key considerations when accumulating stock is the risk of owning too many shares of one single company. Recipients of ESO’s should consider their shares in company stock as one piece of their overall investment strategy and recognize that owning individual stocks can be more volatile than a diversified portfolio. Additionally, owning stock issued by one’s employer could create a dual risk if the business is facing financial hardship. In this scenario, the recipient’s share price could be falling while their job may be at risk.

Holistic Planning for Compensation Packages

When evaluating compensation packages, it is important to assess all benefits presented. While ESOs can provide a compensation enhancement, employees should weigh the features of the program, the outlook for the organization and individual long-term plans. Navigating these details entails thoughtful planning and guidance from a financial and/or tax professional.

For more information on maximizing employee stock options, please feel free to reach out to me or one of the other Consultants in The Wealth Office® at Fiducient Advisors.

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Andrew provides investment consulting services to nonprofit organizations, municipalities, corporate executives, family trusts and other private investors. He supports clients by providing advice and expertise on asset allocation, portfolio design, investment policy statements, manager search process and overall investment management. He also guides clients through an extensive wealth planning process to ensure coordination of investment objectives with their financial planning, estate planning, tax and lending strategies. Andrew joined Fiduciary Investment Advisors LLC in 2014, which combined with Fiducient Advisors in 2020.

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