RBC Rochdale

Planning Opportunities with Equity Compensation

Stock Options

January 2026

Equity compensation is a non-cash award that may come in the form of current and/or future ownership in your employer's stock. In general, it may be offered by private and public companies to attract, retain and motivate employees beyond a salary and cash bonus.

Some of the more common types of equity compensation are stock options, restricted stock units, performance stock units and other types of equity ownership. In navigating the complexities of optimizing equity compensation, it is important to understand the type of equity compensation received, the corresponding tax treatment, and the planning options available.

Stock Options

A stock option is awarded (or "granted") to an employee at certain times over the course of his or her employment. This award is the right to purchase company stock at a set price (often referred to as the "strike price") during a specified period that is usually subject to timing and/or performance restrictions (often referred to as the "vesting period"). Upon completing the vesting period and meeting any other vesting requirements, the employee may then acquire the company stock by exercising the option and purchasing the stock for the strike price. At that point, the employee becomes the legal owner of the company stock and may, generally, hold or sell it at his or her discretion.

Stock options are typically classified into two categories:

1. Incentive Stock Options (ISOs)
2. Nonqualified Stock Options (NQSOs)

ISOs and NQSOs have very similar characteristics, with one major difference — the timing and type of taxation.

Please refer to table on following page for additional detail.

Type of Stock Option	Tax Treatment When Option or Stock Is…			
	Granted	Vested	Exercised	Sold
Incentive Stock Options (ISOs)	None	None	No regular federal tax liability. The number of ISOs exercised, multiplied by the spread[1], is considered a "preference item" for Alternative Minimum Tax (AMT) calculations.	The difference between the fair market value on the date of sale and the fair market value upon exercise is treated as a capital gain.
	A disqualifying disposition[2] may occur if the stock is disposed of within two (2) years from the date of grant or one (1) year from the date of exercise.			
Nonqualified Stock Options (NQSOs)	None	None	The number of NQSOs exercised, multiplied by the spread[1], is treated as compensation income and subject to statutory withholding requirements.	The difference between the fair market value on the date of sale and the fair market value upon exercise is treated as either short-term or long-term capital gain, depending on the holding period.[3]

The Value of Your Stock Options:

Generally speaking, the potential value of stock options only becomes tangible to the holder at two points in time: 1) the time of exercise and; 2) the time of sale or disposition.

Upon exercising any vested stock options, you take legal ownership of the stock, and its value is determined based on the number of options exercised, multiplied by the spread[1]. Keep in mind that you must pay the strike price to the company to exercise the option. This obligation can be satisfied with personal funds, in some cases, via a "sell to cover" arrangement with the company, or if available (varies by company you have stock options in), non-recourse financing .

When you dispose of company stock, the value is determined by the stock's fair market value on the date of sale, less its fair market value on the date of exercise. For tax purposes, this difference is treated as either a short-term or long-term capital gain, depending on how long you held the stock. Note: If you are disposing of stock you own from exercising ISOs, the tax treatment may differ if a disqualifying disposition occurs.

1. The "spread" is the difference between the option's fair market value on the date of exercise and the grant price.
2. Disqualifying dispositions occur when shares are not held for the required holding period, and may result in the shares not receiving preferential tax treatment.
3. A holding period of less than a year from exercise to sale is treated as a short-term capital gain; a holding period of more than a year from exercise to sale is treated as a long-term capital gain.

The Optimal Path:

So, what’s the best approach for exercising options and disposing of stock? Should you hold off on exercising options as they vest? What’s the best way to cover any exercise costs? How long should you wait to dispose of stock once you’ve exercised the option?

The answers to these questions will vary based on your unique financial situation. As you review your overall financial and investment plan to determine the optimal path for you, keep the following considerations in mind:

Holding the Stock Options:

If you anticipate an increase in company value over time, waiting to exercise any stock options until the fair market value of the stock exceeds the strike price could optimize your overall gain. This approach delays potential tax liability until exercise and thus increases the potential gain. Conversely, the larger the spread[1], the greater the potential for an increased tax liability upon exercise.

Note: Options may be subject to vesting requirements prior to exercise and may also have expiration provisions.

Exercising the Stock Options:

If you’ve determined that the appropriate time has come to exercise your stock options, you’ll purchase shares of your company stock at the strike price and pay the associated taxes (if any). You then have the benefit of owning stock in your company, participating in any potential appreciation in stock price, and beginning your holding period for more favorable long-term capital gain treatment upon ultimate disposition (if applicable). Initiate an Exercise-and-Hold Transaction (“Cash Exercise”):

A cash exercise occurs when you use personal assets and/or funds to cover the corresponding exercise costs (i.e., to purchase the stock at its strike price and pay any associated tax liability).

Initiate an Exercise-and-Sell-to-Cover Transaction (“Cashless Exercise”):

Depending on your compensation agreement, you may be able to exercise your options without using personal funds. In this approach, often referred to as a “cashless exercise,” you authorize the company to sell enough of the exercised shares at the time of exercise to cover the exercise cost and taxes. You then take ownership of the remaining number of shares. While a cashless exercise makes it possible to exercise options without using personal funds, it will net you fewer shares than a cash exercise.

Note: Whether or not you can exercise options through a cashless exercise depends on your company’s compensation agreement.

Initiate an Early Exercise:

Some companies may allow for an early exercise of options through an 83(b) election, which allows the option holder to effectively exercise their options and pay the associated taxes on their fair market value at the time of the grant. This approach may result in favorable tax treatment on future appreciation. A valid election that complies with IRC 83(b) requirements must be made within 30 days of the options’ grant and gives the option holder the ability to effectively exercise their options and pay the associated taxes on the fair market value at the time of grant. If your employer offers early exercise, this choice may make sense if you are confident that the value of the shares will increase in the future.

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Exercise and Sell:

For those who are risk-averse and want to minimize their exposure to a concentrated position, an exercise-and-sell approach may be an optimal strategy. Note that the tax consequences of an immediate sale will vary depending on the type of option, and that gains from such a sale may be classified as short-term capital gains or compensation income for tax purposes.

Transferability

In general, stock options are nontransferable assets. But in certain circumstances, your equity compensation agreement may allow transfer under specific conditions and/or with approval from the company's board of directors. In most instances, any transfer of shares can be accomplished with a variety of wealth transfer techniques after the options are exercised.

Expiration/Restrictions

When considering implementation of a strategy with stock options, note that this type of equity compensation expires and may be subject to certain restrictions.

It is important to track exercise periods and expiration dates very closely, because once your options expire, they are worthless. In most cases, there are rules relating to life events — such as termination, retirement, or death — that may accelerate the expiration. Expiration varies from plan to plan; please check your plan rules for details about these dates.

Further, ensure that you understand your company's insider-trading policies and how these could impact your plan. Certain policies may require that stock sales occur during specific trading windows (even through a 10b5-1 plan) or even prohibit planned sales in general.

Conclusion

There is no one-size-fits-all approach to navigating equity-based compensation, and it is important to work with your financial, legal and tax advisors prior to implementing a plan. While considering what strategy may be right for you, it is important to ensure that you are in compliance with your company plan and SEC rules.

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For a deeper dive on concentrated stock positions, refer to our whitepaper here: Concentrated Stocks

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