



# **NaviPlan Extended Online/Offline Self-Study Guide Stock Options**

**USA version 10.2**

EISI, Winnipeg

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# Using the Self-Study Guides

The NaviPlan Extended Self-Study Guides are intended to be used with the NaviPlan Extended Online/Offline application to help you learn how to use NaviPlan.

Each NaviPlan Extended Self-Study Guide covers a different topic. The following topics are covered in these guides:

- Deficit coverage
- Planning strategies
- Life insurance
- Basic life insurance
- Stock options

For information on the Ibbotson Asset Allocation option, contact the EISI Sales department at (888) 692-3474 (press 2 to speak to a sales representative).

**Note:** The NaviPlan Extended Self-Study Guides were created using NaviPlan Extended with the Ibbotson Asset Allocation option. This option allows users to use actual Ibbotson return rates in NaviPlan's calculations. If you are using a version of NaviPlan without the Ibbotson Asset Allocation option, there will be some differences between the guides and your version of NaviPlan.

## Conventions

The NaviPlan Extended Self-Study Guides include the following conventions:

- The names of items that are labeled on the screen are capitalized and italicized. For example,  
The *Clients* page opens.
- Within instructions, the names of items that are labeled on the screen, and items that you must select, click, or type appear in bold. For example,  
Select **My Clients**, and then click **Go**.

## Prerequisites

The self-study guides assume that you are familiar with the basics in NaviPlan Extended. You are able to create a client file and a base plan, and you can use NaviPlan to analyze your clients' ability to meet their current needs.

## Finding more information

If you have a question that is not answered in the self-study guides, there are other places to look for additional help.

### Help

The fastest way to get information about any command, dialog box, or item within NaviPlan Extended Online/Offline is to use the Help.

To access the Help, click the **Help** link at the top of the NaviPlan window.

### support.eisi.com

Visit our Web site to access the following resources:

- Training video clips
- Live Web-based training
- Reference Guides
- Release Notes
- Technical Support
- NaviPlan Support Forums
- NaviPlan User Services

To access these resources, do one of the following:

Click the **Support** link in NaviPlan Extended.

OR

1. Go to [support.eisi.com](http://support.eisi.com).
2. Click **US**.
3. Under *Offline format*, click **NaviPlan Extended Offline**.

OR

You can go directly to

[http://support.eisi.com/support\\_us/npe\\_offline/v10.2/index.htm](http://support.eisi.com/support_us/npe_offline/v10.2/index.htm).

Bookmark or add this page to your favorites in your Internet browser for future reference.

# Stock options

## Learning objectives

This module will enable you to

- Model stock options – See how incentive stock options (ISO) and non-qualified stock options (NSO) are captured in NaviPlan
- Describe the effects of exercising stock options – Examine the cash flow and tax consequences of exercising the options
- Analyze the effects of redeeming stock options – Stock option redemption can be manual or through automatic deficit coverage

NaviPlan Extended only supports the modeling of stock options received as compensation; that is, it does not support the modeling of stock market or derivative options.

You may find it helpful to have NaviPlan Extended open while you work your way through this self-study guide.

## ISO procedure

Let's review what happens in an ISO procedure, and discuss how typical ISO transactions are dealt with in NaviPlan.

1. Stock options are granted. You will enter the date that the stock options were granted and other details in NaviPlan. The stock options may add to the clients' net worth if the strike price is greater than the market value or "above water."
2. The client exercises the option by paying the strike price. In NaviPlan, you can enter the exercise date or select one of the following automatic exercise events: *On Retirement*, *On Death*, *On Expiry*. Cash outflow is created. When the option is exercised
  - NaviPlan automatically treats the exercised option as a stock asset; it pays dividends and grows
  - NaviPlan automatically calculates the alternative minimum tax (AMT) amount
3. Stock is sold either automatically through NaviPlan's default deficit coverage, or you may manually control the sale. NaviPlan automatically calculates the tax liability. Depending on how long the client has held the stock, ISO taxation will vary:
  - If sold early, for example, within five months, NaviPlan calculates compensation income and short-term capital gain
  - If sold after holding periods, for example, after five years, NaviPlan calculates long-term capital gain

## Entering stock options

The *Stock Options* module must be selected on the *Getting Started* section – *Select Modules* category – *Select Modules* page before you can enter the clients' stock options in a Level 1 or a Level 2 Plan.

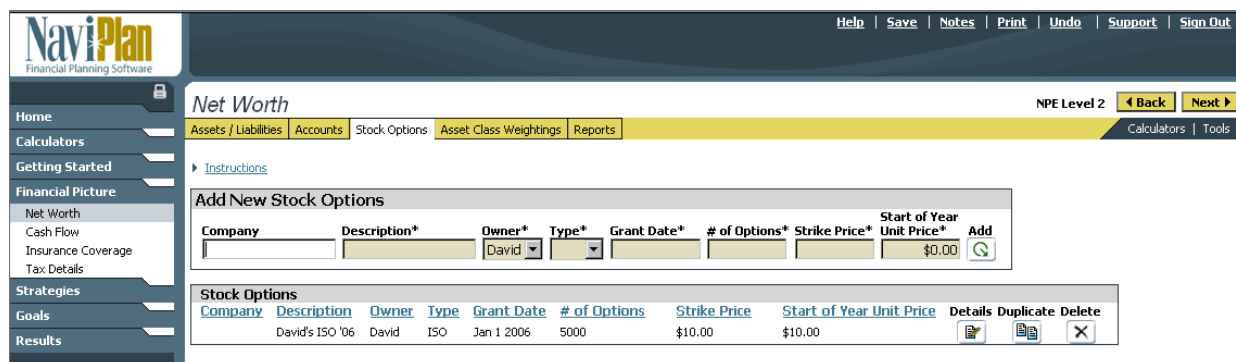


Figure 1: Financial Picture section – Net Worth category – Stock Options page

On the *Stock Options* page, you will enter the basic details of the option that you wish to add.

Under *Description*, it is helpful to include the granting year as part of the description of the stock option since the client is likely receiving very similar options each year.

After you have entered the basic details of the option, click **Add**. The *Stock Options Details* dialog box opens where you can enter details as needed to adjust vesting, expiry, and asset class information. The *Stock Options Details* dialog box has the following five tabs:

- *Details* – Use this tab to define the basic details of the option.
- *Vesting Expiry* – Use this tab to set the vesting schedule and expiry period for the option.
- *Exercise* – Use this tab to direct NaviPlan when to exercise the option.
- *Asset Classifier* – Use this tab to search for specific stocks.
- *Asset Class Weightings* – Use this tab to define actual asset classes.

Once a stock option has been entered, you can save time when entering multiple grants with similar details by duplicating the option (click the **Duplicate** button, and then edit the details).

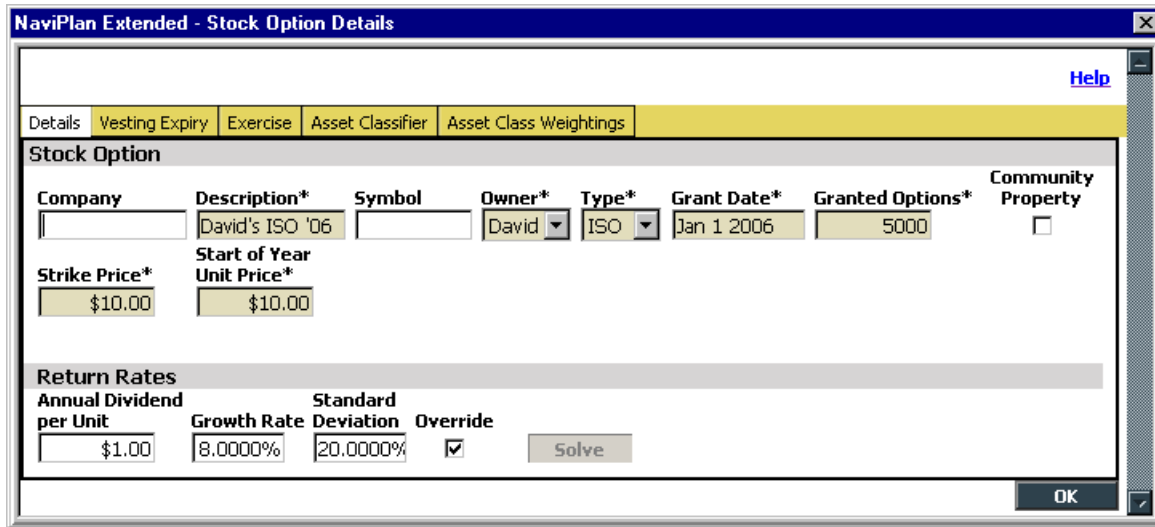


Figure 2: Financial Picture section – Net Worth category – Stock Options page – Details button – Details tab

In Figure 2, the *Override* check box under *Return Rates* was selected, and the user entered data in the *Annual Dividend per Unit*, *Growth Rate*, and *Standard Deviation* fields.

You can use the *Asset Classifier* tab to search for assets that can be applied to the stock option. If the asset is classified, you can first go to the **Asset Classifier** tab, select the asset, and then return to the **Details** tab and click **Solve**. The *Annual Dividend per Unit* and *Growth Rate* fields populate automatically.

You can use the *Asset Class Weightings* tab to manually enter the asset class weightings of a stock option asset. The *Asset Classifier* and the *Asset Class Weightings* tabs work just like they do on the *Financial Picture section – Net Worth category – Accounts* page.

If the asset is not a listed stock, you will likely want to manually enter the details. To access the *Return Rates* fields, you must select the **Override** check box.

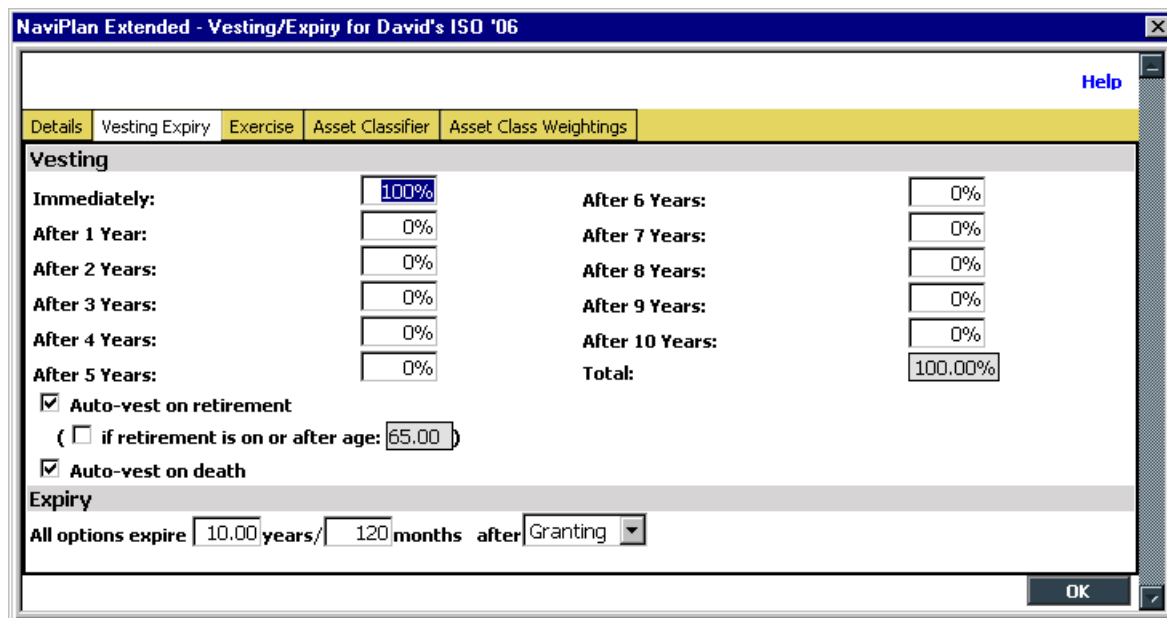


Figure 3: Financial Picture section – Net Worth category – Stock Options page – Details button – Vesting Expiry tab

Let's go to the *Vesting Expiry* tab.

The fields under *Vesting* are used to establish the vesting schedule assigned to the group of options.

Select the *Auto-vest* check boxes when you want NaviPlan to assume that all options will vest at retirement and/or death. You can specify an age when the options will vest in the *if retirement is on or after age* field.

If the options will expire after a certain date, enter the time frame under *Expiry*.

## Exercising stock options

In the *Exercise* dialog box, you can control how options are exercised. This dialog box is used to exercise options received from an employer as compensation and not stock market options.

To get to this dialog box, go to the **Financial Picture** section – **Net Worth** category – **Stock Options** page, and then click the **Details** button next to an option. The *Stock Option Details* dialog box opens. Go to the **Exercise** tab. The *Exercise* dialog box opens.

Exercise Event	Date	# of Options to Exercise		Market Value / Unit when Exercised		# of Options Sold Prior to Current Year	Cashless	
		All Vested	Specify	Calculate?	Specify (\$)		Activate?	Est. Tax Rate
On Expiry	Jun 1 2010	<input checked="" type="checkbox"/>	0	<input checked="" type="checkbox"/>	\$0.00	0.00	<input type="checkbox"/>	0%
On Expiry		<input checked="" type="checkbox"/>	0	<input checked="" type="checkbox"/>	\$0.00	0.00	<input type="checkbox"/>	0%
On Death		<input checked="" type="checkbox"/>	0	<input checked="" type="checkbox"/>	\$0.00	0.00	<input type="checkbox"/>	0%
		<input type="checkbox"/>	0	<input checked="" type="checkbox"/>	\$0.00	0.00	<input type="checkbox"/>	0%
		<input type="checkbox"/>	0	<input checked="" type="checkbox"/>	\$0.00	0.00	<input type="checkbox"/>	0%
		<input type="checkbox"/>	0	<input checked="" type="checkbox"/>	\$0.00	0.00	<input type="checkbox"/>	0%
		<input type="checkbox"/>	0	<input checked="" type="checkbox"/>	\$0.00	0.00	<input type="checkbox"/>	0%
		<input type="checkbox"/>	0	<input checked="" type="checkbox"/>	\$0.00	0.00	<input type="checkbox"/>	0%

Figure 4: Financial Picture section – Net Worth category – Stock Options page – Details button – Exercise tab

This dialog box has paired columns. For example, under *Exercise* you can select an *Event* or enter a *Date*. Under *# of Options to Exercise*, you can select the *All Vested* check box or use the *Specify* field. Under *Market Value / Unit when Exercised*, you can select *Calculate?* or *Specify (\$)*. Under *Cashless*, you can select *Activate?* or *Est. Tax Rate*. Only the *# of Options Sold Prior to Current Year* is a single column.

Multiple rows are available so that you can exercise the options at multiple times. The *Vesting Expiry* tab and the *Exercise* tab work together. For example, if you set up phased vesting on the *Vesting Expiry* tab, and if you select *All Vested* under *# of Options to Exercise* on the *Exercise* tab, only those options that have vested by the exercise date will be exercised.

By default under *Event*, *On Death* and *On Expiry* are automatically selected. You can also select *On Retirement* from this list. In our example, the planner has entered a fixed date because the client, David, plans to exercise the options on June 1, 2010.

Under *# of Options to Exercise*, you can set how many options to exercise: *All Vested* or *Specify* a number. This is useful with phased vesting.

Under *Market Value / Unit when Exercised*, if the *Calculate?* check box is selected, NaviPlan uses the growth rate assigned on the *Details* tab to calculate the value. If the *Calculate?* check box is not selected, a value must be entered under *Specify* (\$).

NaviPlan will only accept one exercise value per month so if you're planning on using two exercise dates very close together with different values, they must be entered at least one month apart. For example, if 500 options are exercised on October 10 at a market value of \$15 and another 500 are exercised on October 25 at a market value of \$20, all 1,000 options will be exercised at the October 25 market value of \$20, since NaviPlan only accepts one date per month and uses the latest date entered. To have the options exercised at the two different market values, the exercise dates must be at least one month apart.

Under *# of Options Sold Prior to Current Year*, you can enter the number of stock option units that were sold before January 1 of the plan year. When a plan is incremented from a previous year, NaviPlan populates these fields automatically.

If the clients cannot afford the exercise price, then it can be helpful to use the *Cashless* feature. Under *Cashless*, select the *Activate?* check box, and then under *Est. Tax Rate*, enter the probable tax rate applicable to any income realized. When the *Cashless* feature is activated, NaviPlan sells enough of the exercised options to cover the entire cost of the exercise as well as the estimated tax liability (based on market value at exercise date).

## Exercising stock options and effects on net worth

Remember the ISO procedure that was discussed at the beginning of this guide? This section illustrates step 2 of the ISO procedure. After the stock option is exercised by paying the strike price, NaviPlan automatically treats the asset as a stock which pays dividends and grows. NaviPlan automatically calculates the AMT amount.

Take a look at the *Single Asset Details* report to see the effects on the clients' net worth. This report tracks asset details such as unit price, buys, sells, cost basis, and number of units on a month-by-month basis.

## Exercising stock options and effects on cash flow

Let's take a look at the *Cash Flow Assistant* for the year 2010 to see how exercising the stock options affects the clients' cash flow.

Description	Head1	Head2	Family
Employment Income	175,579	114,802	290,381
Investment Income	491,452	385,323	876,775
Pension Income	0	0	0
Total Income	667,032	500,125	1,167,157
Total Tax	105,682	52,508	158,190
Income after Tax	561,350	447,617	1,008,967
Lifestyle Expenses	152,519	151,919	304,439
Pension Contributions	4,389	5,700	10,089
Investment Purchases	62,412	1,323	63,735
Investment Expenses	300,000	300,000	600,000
Current Surplus/(Deficit)	42,029	11,325	30,704
Previous Surplus/(Deficit)	334,484	0	334,484
Funds (to)/from other members	11,325	11,325	0
Ending Surplus/(Deficit)	365,188	0	365,188

Figure 5: Tools menu – Cash Flow Assistant selection – Cash Flow Assistant dialog box (after stock options exercised)

The exercise of options is treated as an investment purchase in the *Cash Flow Assistant* or as a non-qualified contribution in the *Itemized Cash Flow* report.

When you click on specific value cells in the *Cash Flow Assistant*, you can see more details. For example, when a value on the *Investment Income* line is clicked, a *Detailed Information* dialog box opens and shows dividends.

**Detailed Information**

**Investment Income Details for David in 2010:**

Asset Name	Interest	Dividend	Capital Gain	Tax Free	Rental
Joint NQ	\$1,268	\$0	\$0	\$0	\$0
Brampton Crest International Incorporated	\$0	\$2,513	\$8,631	\$0	\$0
500 Smith Street	\$0	\$0	\$0	\$0	\$384,000
David's ISO '06	\$0	\$5,000	\$0	\$0	\$0
<b>Total</b>	<b>\$1,268</b>	<b>\$7,513</b>	<b>\$8,631</b>	<b>\$0</b>	<b>\$384,000</b>

Trust Name	Interest	Dividend	Capital Gain	Tax Free	Rental
David's portion of Train family trust	\$33,765	\$33,765	\$22,510	\$0	\$0
<b>Total</b>	<b>\$33,765</b>	<b>\$33,765</b>	<b>\$22,510</b>	<b>\$0</b>	<b>\$0</b>

Figure 6: Tools menu – Cash Flow Assistant selection – Cash Flow Assistant dialog box – Investment Income line

Any dividends from the exercised options are included in cash flow going forward. They are not assumed to be reinvested.

In the *Cash Flow Assistant*, when David's value cell for *Employment Income* is clicked, the following *Detailed Information* dialog box opens.

**Detailed Information**

**Employment Income Details for David in 2010:**

Income Source	Amount
Salary	\$175,579
<b>Total</b>	<b>\$175,579</b>

Figure 7: Tools menu – Cash Flow Assistant selection – Cash Flow Assistant dialog box – Employment Income line

David did not receive any compensation cash flow other than his salary. No additional income sources were added. Why? The benefit of ISOs is deferred compensation and preferential tax treatment. No cash flow is received upon exercise of ISO stock options aside from dividends.

NaviPlan calculates AMT tax income as follows:

$$(\text{market value} - \text{strike price}) \times \text{number of options exercised.}$$

## Redeeming stock options

Redeeming stock options is step 3 of the ISO procedure that was discussed at the beginning of this guide. Like all other investments, stock options are available for deficit coverage by default, so automatic sales may happen.

To ensure that no automatic sales occur, you must remove the deficit coverage strategy for the stock option account.

Redeeming stock options creates cash inflow and realizes taxable income. Given the short time frame between exercise and sale, David's stock option redemption results in compensation income for the original *gain* at exercise and short-term gain for any growth since the stock options were exercised.

Let's take a look at the *Stock Option Activity (Gross \$)* report to see the effects of redeeming the stock options. This report is generated on the *Results* section – *Additional Reports* – *Net Worth* category – *Stock Options* page. For this report, we have chosen to look at David's results only.

Stock Option Activity (Gross \$)												
Intermediate and Train												
Stock Options (2006)												
(David)												
Year	Age(s)	Gross Granted	Gross Vested	Amount Paid to Exercise	Gross Exercised	Gross Expired	Taxable Compensation Income	A.M.T. Income	Gross Sold	Net Value		
2006	40/38	54,000	54,000	0	0	0	0	0	0	4,000		
2007	41/39	0	0	0	0	0	0	0	0	8,320		
2008	42/40	0	0	0	0	0	0	0	0	12,986		
2009	43/41	0	0	0	0	0	0	0	0	18,024		
2010	44/42	0	0	50,000	73,466	0	0	22,375	0	73,466		
2011	45/43	0	0	0	0	0	22,375	1,091	73,466	0		
2012	46/44	0	0	0	0	0	0	0	0	0		
2013	47/45	0	0	0	0	0	0	0	0	0		
2014	48/46	0	0	0	0	0	0	0	0	0		
2015	49/47	0	0	0	0	0	0	0	0	0		
2016	50/48	0	0	0	0	0	0	0	0	0		
2017	51/49	0	0	0	0	0	0	0	0	0		
2018	52/50	0	0	0	0	0	0	0	0	0		
2019	53/51	0	0	0	0	0	0	0	0	0		
2020	54/52	0	0	0	0	0	0	0	0	0		
2021	55/53	0	0	0	0	0	0	0	0	0		

Figure 8: Stock Option Activity (Gross \$) report

In 2006, the stock options were granted and vested. Note the entries under *Gross Granted* and *Gross Vested* for \$54,000.

The *Gross* and *Net* columns throughout the report represent end-of-year values. Since *David's ISO '06* stock options were 100% vested, the full value is shown in 2006.

In 2007–2009, under *Net Value*, note that the options continue to increase in value but they are still just options here.

In 2010 (the year the stock options were exercised), note the *Amount Paid to Exercise* is \$50,000, the *Gross Exercised* is \$73,466, and the *A.M.T. Income* is \$22,375.

- NaviPlan calculates the *Gross Exercised* value as follows:  
market value @ end of year × number of shares.
- *A.M.T. Income* is based on the value at the time the stock options are exercised. This value is often different than the difference between *Gross Exercised* and *Amount Paid to Exercise* because *Gross Exercised* uses end-of-year values and *A.M.T. Income* does not.

In 2011 (the year the stock options are redeemed), note the *Taxable Compensation Income* is \$22,375, the *A.M.T. Income* is \$1,091, and the *Gross Sold* amount is \$73,466. Because of the short holding period between the exercise and the sale, the AMT income amount is added back for regular tax purposes and becomes regular compensation. Also, any growth that occurs between the exercise date and sale becomes additional AMT taxable income.

Now let's take a look at the *Cash Flow Assistant* for 2011 (the year the stock options are redeemed).

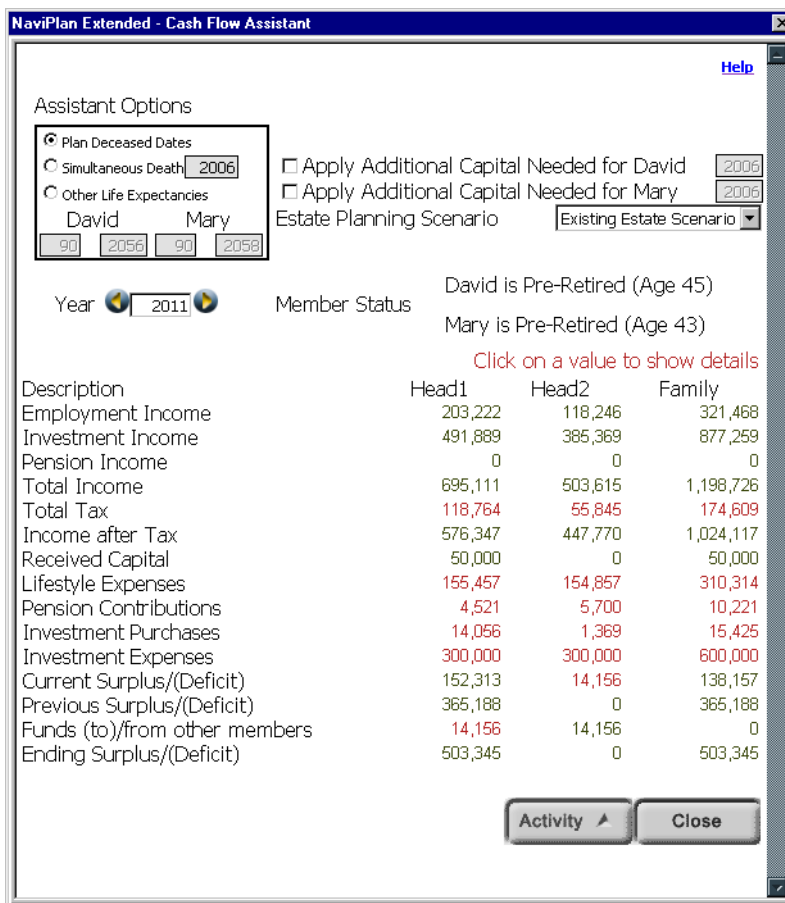


Figure 9: Tools menu – Cash Flow Assistant selection – Cash Flow Assistant dialog box (after stock options are redeemed)

Compensation income is included in *Employment Income*. Growth income appears as part of *Investment Income*.

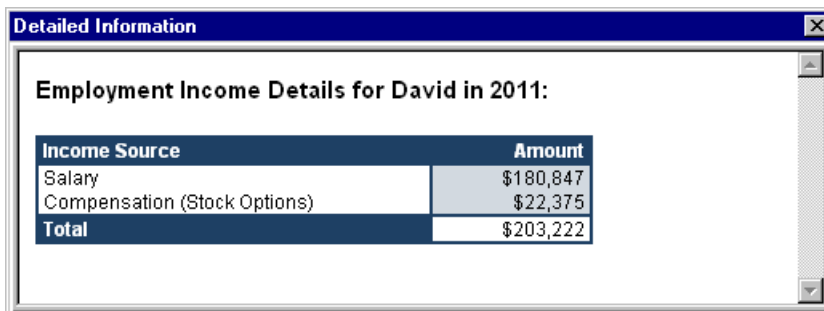


Figure 10: Tools menu – Cash Flow Assistant selection – Cash Flow Assistant dialog box – Employment Income line

**Detailed Information**

**Investment Income Details for David in 2011:**

Asset Name	Interest	Dividend	Capital Gain	Tax Free	Rental
Joint NQ	\$1,314	\$0	\$0	\$0	\$0
Brampton Crest International Incorporated	\$0	\$2,873	\$9,869	\$0	\$0
500 Smith Street	\$0	\$0	\$0	\$0	\$384,000
David's ISO '06 <sup>1</sup>	\$0	\$0	\$1,091	\$0	\$0
<b>Total</b>	<b>\$1,314</b>	<b>\$2,873</b>	<b>\$10,960</b>	<b>\$0</b>	<b>\$384,000</b>

**Footnotes:**

1. Includes **\$23,466** in *Capital Gains* from the following redemptions of David's ISO '06:  
 - the *Tax Free* portion (\$50,000) appears under the *Received Capital* heading.

Trust Name	Interest	Dividend	Capital Gain	Tax Free	Rental
David's portion of Train family trust	\$34,778	\$34,778	\$23,185	\$0	\$0
<b>Total</b>	<b>\$34,778</b>	<b>\$34,778</b>	<b>\$23,185</b>	<b>\$0</b>	<b>\$0</b>

Figure 11: Tools menu – Cash Flow Assistant selection – Cash Flow Assistant dialog box – Investment Income line

Even though this report doesn't show it, we know that the investment income resulting from the redemption is a short-term capital gain because of the short holding period. The *Income Activity* report, generated from the *Cash Flow Assistant*, shows income activity in more detail.

Income Source	Member	Current Amount
Employment		
Salary		
Salary	David	180,847
Salary	Mary	118,246
Interest		
	David	1,314
	Mary	1,314
Dividend		
	David	2,873
	Mary	55
Short Term Capital Gains	David	1,091
Long Term Capital Gains	David	9,869
Rental		
	David	384,000
	Mary	384,000
Compensation (Stock Options)	David	22,375
Cost Basis	David	50,000
Interest	David	34,778
Dividend	David	34,778
Short Term Capital Gains	David	23,185
<b>Total</b>		<b>1,248,726</b>

Figure 12: Tools menu – Cash Flow Assistant selection – Cash Flow Assistant dialog box – Activity button – Income Activity selection

The rest of the stock option sale proceeds is shown in the *Cash Flow Assistant* as *Received Capital* (\$50,000).

This situation could be improved for the clients by exercising earlier or redeeming later. You should ensure that there are at least two years between the grant and exercise dates, and that there is at least one year between the exercise date and the redemption date.

## NSO procedure

The only difference between the ISO procedure and the NSO procedure is the type of income triggered and when taxation occurs.

Let's review what happens in an NSO procedure, and discuss how typical NSO transactions are dealt with in NaviPlan.

1. Stock options are granted. You will enter the date that the stock options were granted and other details in NaviPlan. The stock options may add to the clients' net worth if the strike price is greater than the market value or "above water."
2. The client exercises the option by paying the strike price. In NaviPlan, you can enter the exercise date or select automatic exercise events: *On Retirement*, *On Death*, *On Expiry*. Cash outflow is created. When the option is exercised
  - NaviPlan automatically treats the exercised option as a stock asset; it pays dividends and grows.
  - The gain is automatically treated as compensation income for tax purposes but this amount does not appear in cash flow because the stock is not sold at this point. This usually results in the client having a large tax liability without any additional cash flow or income to pay for it. By activating the *Cashless* feature, you can ensure that NaviPlan will sell enough of the shares to pay the tax liability.
3. Stock is sold. The options may be sold automatically through NaviPlan's default deficit coverage, or you may manually control the sale. NaviPlan automatically calculates the tax liability. If the market value has increased since the stock options were exercised, the difference or growth is taxed as capital gains according to the regular holding period rules.

## Exercises

The following exercises have been designed specifically for this module and assume that you are working with the original data in the *Core and Elective Base* plan. Before starting the exercises, duplicate the **Core and Elective Base** plan, rename the duplicate with a meaningful name (e.g., *Stock option training*), and then use it to complete the exercises below.

To find the answers, see “Answers to stock options” on page 24.

### Part A – David’s ISO option

David would like to exercise and sell his company stock to pay for a new motorcycle he wants for his 45<sup>th</sup> birthday. Mary calls it his “mid-life crisis” bike. Since this is his first grant of stock options, David is not very familiar with the benefits of his incentive stock options (ISO). In this exercise you will use various NaviPlan reporting and stock option features to suggest a stock option exercise and redemption plan for David’s ISO.

#### Exercise 1: Model stock options

1. In general, to specify **return rates** for stock options in NaviPlan, which options can be used?
  - a) Select **Override** in the details of the stock option, and then enter the details manually.
  - b) Go to the **Asset Classifier** tab to search for and populate a specific stock.
  - c) Manually assign the **asset class weightings** of the stock option.
  - d) All of the above.

#### Exercise 2: Describe the effects of exercising stock options

1. If David exercises his option in June 2012, what type of cash inflow can he expect in 2012?

**Hint:** The plan does not have a redemption strategy entered yet. The *Cash Flow Assistant* provides details of the entire plan’s cash flow.

- a) Employment/compensation income
- b) Dividends
- c) Short-term capital gains
- d) Long-term capital gains

2. How much **alternative minimum tax (AMT)** income is triggered upon the exercise of David's **ISO** in 2012?

**Hint:** The AMT section can be expanded in the *Income Tax Details* report.

- a) \$0–\$5,000
- b) \$5,001–\$15,000
- c) \$15,001–\$25,000
- d) Over \$25,000

### Exercise 3: Analyze the impact of redeeming stock options

1. Use the **Strategies** category – **Redemptions** page to redeem all of David's options on April 2013 (his birthday). Which of the following cash inflows from the stock options will be received in 2013?

**Hint:** Take note of the stock option details in the **Investment Income** cell in the **Cash Flow Assistant** for 2013, and then use the **Income Activity** report.

- a) Employment/compensation income
  - b) Received capital
  - c) Capital gains
  - d) All of the above
2. You realize that the above strategy does not make use of the ISO tax advantages. David wants this cash available for his birthday, so delaying the redemption of the options is not realistic. If the options were exercised earlier it might improve the situation. Change the exercise date to **January 2012**, and then answer the next question.
  3. Is the following statement true or false? The cash from the stock redemption in 2013 is treated as **Employment/Compensation** income.
    - a) True
    - b) False

## Part B – Mary’s NSO option

Mary was granted some NSOs on January 1, 2009. She would like to help David with his motorcycle purchase, so she too will exercise and sell her shares. However, she does not want to use her cash on hand to pay for the exercise price. In the following questions, you’ll use NaviPlan’s features, like the *Cashless* exercise of stock options to show Mary how she can help David with more cash flow.

To find the answers, see “Answers to stock options” on page 24.

### Exercise 1: Model stock options

1. In January of this year Mary’s employer awarded her the option to purchase **5,000** shares in the company at a *strike price* of \$5.00, equal to the *Start of Year Unit Price*. The *Annual Dividend per Unit* paid on the stock is **\$0.25**, the *Growth Rate* is **8.0%**, and the *Standard Deviation* is **18%**. These NSO options are subject to a vesting schedule where **25%** are available immediately and the remaining shares will vest **25%** per year over the next three years. The options will **auto-vest** on Mary’s retirement date or at death. The options came with a provision that stipulates an expiration date **10 years after granting**. Enter the above details of Mary’s option into the plan.
2. Generate a **Stock Option Activity (Gross \$)** report. Which is the last year that options will vest?

**Hint:** Be sure to only include Mary when assigning the report settings.

- a) 2010
- b) 2011
- c) 2012
- d) 2013

### Exercise 2: Describe the effects of exercising stock options

1. Why are the options being exercised in 10 years?

**Hint:** Review the default settings on the *Exercise* tab for the stock option.

- a) NaviPlan automatically exercises options **On Expiry**.
- b) NaviPlan automatically exercises options **On Death**.
- c) NaviPlan automatically exercises options **On Retirement**.
- d) NaviPlan automatically exercises options after **10 years**.

# HANDS-ON EXERCISES

2. All options will be fully vested in January 2013; enter an exercise date of **Feb. 2013** to exercise the *All Vested* options. With this exercise date, which of the following statements is false?
  - a) The difference between the market value on the exercise date and the strike price will be treated as compensation income.
  - b) Any growth between February 2013 and the sale date in April 2014 will be treated as compensation income.
  - c) Exercising in February 2013, instead of closer to the redemption date, will save taxes because any growth will be treated as a long-term gain and taxed at a lower rate than compensation income.
  - d) Any growth between February 2013 and the sale date in April 2014 will be treated as long-term gains income.
3. Since Mary does not want to use her cash for the February 2013 exercise, use the **Cashless** feature to model a cashless exercise. David and Mary are in the **35%** tax bracket, so use this to estimate the amount of tax to be covered by the cashless exercise.
4. Generate a **Single Asset Details** report for Mary's **NSO** to answer questions 5 and 6.
5. What is the sell amount for the cashless exercise?
  - a) \$0-\$10,000
  - b) \$10,001-\$25,000
  - c) \$25,001-\$40,000
  - d) Over \$40,000
6. What is the change in units for the cashless exercise?
  - a) 0-200
  - b) 201-400
  - c) 401-600
  - d) Over 600

### Exercise 3: Analyze the impact of redeeming stock options

To find the answers, see “Answers to stock options” on page 24.

1. If Mary redeems all remaining units of the options for David’s birthday (April 2013), how much investment income from all stock options will be available for David to purchase his motorcycle?

**Hint:** Use the **Strategies** category to implement the strategy and the **Cash Flow Assistant** to analyze it.

- a) \$0–\$15,000
- b) \$15,001–\$30,000
- c) \$30,001–\$45,000
- d) Over \$45,000

## Conclusion

This module has enabled you to

- Model stock options
- Describe the effects of exercising stock options
- Analyze the effects of redeeming stock options

# Answers to stock options

## Part A – David's ISO option

### Exercise 1: Model stock options

1. d) All of the above. All of the options listed can be used to specify return rates in NaviPlan.

### Exercise 2: Describe the effects of exercising stock options

1. b) Dividends will enter into cash flow in 2012 when David exercises his options in June.
2. c) \$0–\$5,000 in alternative minimum tax (AMT) income is triggered upon the exercise of David's ISO in 2012.

### Exercise 3: Analyze the impact of redeeming stock options

1. d) All of the above cash inflows from the stock options will be received in 2013.
3. b) False. The cash from the stock redemption in 2013 is **not** treated as *Employment/Compensation* income.

## Part B – Mary's NSO option

### Exercise 1: Model stock options

2. d) The last year that options will vest is 2013.

### Exercise 2: Describe the effects of exercising stock options

1. a) The options are being exercised in 10 years because NaviPlan automatically exercises options **On Expiry**.
2. b) The statement "Any growth between February 2013 and the sale date in April 2014 will be treated as compensation income" is false.
5. c) \$25,001–\$40,000 (approximately \$27,000) is the sell amount for the cashless exercise.
6. d) Over 600 (approximately 695) is the change in units for the cashless exercise.

### Exercise 3: Analyze the impact of redeeming stock options

2. b) \$15,001–\$30,000 in investment income from all stock options will be available for David to purchase his motorcycle.

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