Understanding Stock Options

Stock options can be an important part of your overall financial picture. Understanding what they are can help you make the most of the benefits they may provide.

How Do Options Work?
Stock options, once vested, give you the right to purchase shares of your company’s stock at a specified price, usually called the strike or exercise price. Each option allows you to purchase one share of stock. The value of a stock option depends on the price of the company’s shares, which fluctuates over time.

A stock option is said to be “vested” when the holder has the right to exercise the stock option and purchase the shares at a predetermined price. The stock options may vest over a set schedule. Details regarding the grant, including, but not limited to the exercise price, expiration date, and vesting schedule are described in your grant agreement. The exercise price, vesting schedule, and expiration date for each of your option grants are displayed on the My Stock Plan Holdings page on etrade.com. You can access this page by selecting My Stock Plan from the Accounts menu on etrade.com, and then clicking Holdings.

As an example, consider if you were given a grant of 100 stock options at $10 dollars each. After a vesting period of three years, the company’s share price has risen to $25. You are now entitled to buy the shares for the exercise price of $10, a full $15 below the current stock price. This process of purchasing the shares underlying the option is known as “exercise”.

Know the Types of Stock Options
Details regarding your options will be covered in the grant documents provided by your company. Before taking action on your Stock Options, review the company’s plan documents on the Company Resources page (Accounts > My Stock Plan > Company Resources). The type of stock options you have been granted will be listed on the My Stock Plan Holdings page (Accounts > My Stock Plan > Holdings) on etrade.com.

Incentive stock options (ISOs)
Incentive stock options (ISOs) are eligible for preferential tax treatment. Taxes are not due at exercise. Rather, the taxes due are deferred until the holder sells the stock received following option exercise. Among other requirements, as long as the sale is at least two years after the options were granted and at least one year after they were exercised, any proceeds will be subject to taxation at the lower, long-term capital gains rate. If these holding periods are not met, the sale will be considered a disqualifying disposition. A disqualifying disposition subjects a portion of the sale proceeds to taxation as ordinary income. The amount of ordinary income will be the difference between the price on the date of exercise and the cost to acquire the shares (the grant or exercise price). If shares are held after exercise, the eventual gain or loss when the shares are sold would be treated as a short-term or long-term capital gain based on the holding period.

Non-Qualified Stock Options (NQSOs)
Non-qualified stock options (NQSOs) are not eligible for preferential tax treatment when exercised. In contrast to ISOs, non-qualified stock options result in additional taxable income to the recipient at the time that they are exercised, the amount being the difference between the exercise price and the market value on that date. If shares are held after exercise, the eventual gain or loss when the shares are sold would be treated as a short-term or long-term capital gain based on the holding period.

Exercise Types
Same-Day Sale (Cashless Exercise) – Immediately sell the shares in the open market. Some of the proceeds from the sale will be used to pay the costs of exercise and the rest (if any) will be deposited into your account.

Cash Exercise (Exercise & Hold) – Deposit cash into your account and buy shares at the exercise price. Shares will be deposited into your account.

Sell-to-Cover – Some of the resulting shares are sold to pay the exercise costs. Whatever shares remain (if any) are deposited into your account.
U.S. Tax Information

Before you take action, you’ll want to carefully consider any possible tax consequences. Tax treatment for each transaction depends on the type of option you own. **For advice on your personal financial situation, please consult a tax advisor.**

**Taxes on Exercise**
- **Incentive Stock Options (ISO)** – In most cases, no taxes are due at exercise.
- **Non-Qualified Stock Options (NQSO)** - Taxes at exercise are based on the difference between the current share price and the exercise price. This amount is typically taxable in the year of exercise at ordinary income rates.

**Taxes at Sale**
- **Incentive Stock Options (ISO)**

  **Ordinary Income:** The amount of ordinary income recognized when you sell your shares from an ISO exercise depends on whether you make a qualifying or disqualifying disposition. A sale of shares from an ISO exercise can be considered a qualifying disposition and possibly result in favorable tax treatment if, among other requirements, the following conditions are met:

  1. You do not sell the shares for at least two years and one day after the option grant date, and
  2. You do not sell the shares for at least one year and one day after the date of purchase (the exercise date).

  In general, selling shares from an ISO exercise in a qualifying disposition will not trigger ordinary income and the entire gain or loss (sales price minus cost of the shares) will be considered a long-term capital gain or loss. If you fail to satisfy the requirements described above, your sale of shares from an ISO exercise might be considered a disqualifying disposition.

  In general, selling stock in a disqualifying disposition will trigger ordinary income. The amount of ordinary income is generally the difference between the stock price on the date of the exercise and the option exercise price. The ordinary income from the disqualifying disposition will appear on your Form W-2 or other applicable tax document, issued by your employer. Any remaining gain or loss will be considered short-term or long-term, depending on how long you held the shares after exercise. If you held the shares one year or less, the gain or loss would be short-term. If you held the shares more than a year, the gain or loss would be long-term.

- **Non-Qualified Stock Options (NQSO)**

  **Ordinary Income:** No additional ordinary income is recognized upon the sale of shares from a Non-Qualified Stock Option exercise.

  **Capital Gain or Loss:** Any difference between the stock price on the exercise date and the stock price at sale will be treated as a capital gain or capital loss. If shares are held for at least one year and one day after exercise, any resulting gain is typically treated as a long-term capital gain.

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## U.S. Tax Information

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### Taxes on Dividends

If you exercise your options and hold the shares, any dividends received on your shares are considered income and are taxed as such in the year they are received.

### A Closer Look at Potential Tax Scenarios for Each Option Type

This example assumes a $10 exercise price on a grant of 100 options. The stock price at exercise is $25. The stock price at sale is $45.

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<tr>
<th>OPTION TYPE</th>
<th>TAXES AT EXERCISE</th>
<th>TAXES AT SALE</th>
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</table>
| **Incentive Stock Option (ISO)** | In most cases, no taxes are due at exercise | **Scenario 1: Qualifying Disposition:** $45 - $10 = $35  
100 shares X $35 = $3,500 taxed as capital gains (long term) |
|                           |                                    | **Scenario 2: Disqualifying Disposition:** 100 shares X ($25-$10) = $1,500 taxed as ordinary income  
$45 - $25 = $20  
100 shares X $20 = $2,000 taxed as capital gains (long term or short term depending on how long shares were held) |
| **Non-Qualified Stock Option (NQSO)** | $25 - $10 = $15  
100 shares X $15 = $1,500 taxed as ordinary income | $45 - $25 = $20  
100 shares X $20 = $2,000 taxed as capital gains (long term or short term depending on how long shares were held) |
Exercising Your Options

Once you exercise your vested options, you can sell the shares (subject to any company imposed trading restrictions or blackout periods) or hold them until you choose to sell.

Follow these steps to create an order to exercise your options and hold or sell your shares:

1. Create Order
   A. Log on to etrade.com. From the Stock Plan Overview page, click the Exercise tab
   B. Choose to exercise your options and hold or sell the resulting shares by selecting one of the following:
      a. Cash: “I’d like to sell the resulting shares and receive cash”
      b. Shares: “I’d like to receive shares”
   C. If you choose cash, choose your price type by selecting one of the following:
      a. Market: “I’d like to sell at the next available market price”
      b. Limit: “I’m willing to wait until the stock reaches a specific price”
   D. If you choose shares, choose how you would like to fund the exercise:
      a. Sell-to-Cover: “I’d like to sell shares to cover the cost of the exercise”
         i. Market: “I’d like to sell at the next available market price”
         ii. Limit: “I’m willing to wait until the stock reaches a specific price”
      b. Cash/Margin: “I’d like to use cash or margin to cover the cost of the exercise”
   E. Choose Options to Exercise: Enter the number of options you would like to exercise from the available lots
   F. Select how you would like to receive your cash proceeds

2. Preview Order
   G. Review your order and estimate your proceeds by clicking the Preview Order button
   H. From the Preview Order page, you can change or cancel your order; click Place Order when you are ready to place your order

3. Confirm Order
   I. You will receive a confirmation that your order has been placed

We’ll alert you when your order has been executed and when settlement occurs.
You can also track your order status on the Orders screen (My Stock Plan > My Accounts > Orders) on etrade.com.
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Visit our Customer Service Online at etrade.com/service or call us at 1-800-838-0908, 24 hours a day, weekdays. From outside the U.S. or Canada, call +1 650 599 0125. One of our dedicated professionals will be happy to assist you.

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