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"Tax complexity itself is a kind of tax" **Max Baucus**

Employer compensation packages often include an equity component. This means you've been awarded shares of stock in the company or an offer that allows you to buy shares of stock in the company. Start-ups often offer stock as a supplement to cash compensation. The potential for ever increasing stock value is motivational to employees and allows a business to use current cash flow elsewhere. Equity compensation is also offered in many established companies to encourage retention, motivation, and performance. Equity compensation has varying and often complex tax rules. The first step in making the most of your equity benefits is to understand the potential value of equity compensation as well as the potential risk involved. This will help when evaluating how best to utilize the shares within your overall financial plan.

Here we will discuss some of the most common types of equity compensation plans.

RESTRICTED STOCK UNITS (RSU)

Restricted stock units (RSUs) are a promise to give shares of company stock to an employee on a specified date. This time requirement is called vesting. RSUs are a representation of company shares – the shares are not owned until their vesting date. RSU vesting is always contingent upon meeting the terms specified by the company. These terms can be performance based (company or individual), time based, or both. All details regarding vesting will be found within the award letter or plan documents. Upon vesting, the employee will pay ordinary income tax and payroll taxes on the fair market value of the shares on the vesting date. Generally some shares are given back to the company to be used to pay the tax owed. On the vesting date you now own the shares, and if held for 366 days (at least one year), they will receive preferential tax treatment as capital gains on any increase in the value of the stock. If not held for greater than one year, any gain is taxed at ordinary income rates. Because these shares are given to an employee, they are sometimes sold immediately at vesting when there is unlikely to be any gain or loss. Selling the shares immediately minimizes price risk and the potential for unfavorable tax treatment. RSUs are the most common form of equity compensation and are provided to both rank-and-file employees as well as executives. In addition to the vesting terms, some recipients of RSUs will be subject to restrictions based upon their proximity to material non-public information regarding the company and will also have specific time windows when they are allowed to sell company stock.

RESTRICTED STOCK AWARDS (RSA)

A Restricted Stock Award is another type of equity grant that is often confused with Restricted Stock Units. The main difference between the two is timing of ownership. Stock granted by an RSU is not owned until vested, whereas stock granted/purchased via an RSA is owned at the time of grant though with an additional vesting condition attached, such as a time based or liquidation clause. The addition of this restriction allows the RSA to be eligible for an 83(b) election, which is a tax strategy that allows for pre-payment of the taxes at grant rather than at the vest date. Paying the income taxes up front could be fruitful if the company's share price is anticipated to increase significantly before the grants vest, the company goes public, or is sold. Additionally, an 83(b) election starts the capital gains holding period with the grant date. There are risks of making this election as there are no refunds of the tax payment regardless of what subsequently happens to the stock price or if employment ends prior to the RSA conditions being met. If an 83(b) election is not made, ordinary income taxes are owed when they vest and are calculated on the difference between the grant price and the fair market value, with the capital gains holding period starting at the vest date. There can also be black-out periods for insiders who receive restricted stock awards just as those who receive restricted stock units.

NONQUALIFIED STOCK OPTIONS (NQSO)

A stock option gives the holder of the option the right to buy a specific number of shares of a company's stock at a predetermined price (exercise price). This option is valid for a fixed period (expiration date), and also has a time-based vesting component. NQSOs are granted to employees at a discount from the stock price on the grant date and are a form of compensation. Upon vesting, the option holder determines if/when to exercise their right and purchase the stock.

The stock option is only worth exercising if the current company stock price is more than the exercise price, also known as being "in the money". When exercising, the employee will need to purchase the stock at the grant price and will also owe tax on the discount they received on the stock. This 'discount' is the difference between the price paid and the fair market value of the stock on the option exercise date and is considered the compensation component causing this amount to be subject to federal, state, and payroll taxes. Some companies offer a cashless exercise which allows some of the shares to be sold to pay for the cost of the shares, the tax, or both. If there is no cashless option, other funds would be required to cover the cost. In rare instances, an 83(b) election may be allowed for specific types of NQSOs. If the shares are held for more than a year, subsequent gains on sale proceeds would qualify for long term capital gains rates. Because the rules for NQSOs are complex, tax planning, and choosing when and how much to exercise are essential in putting together a game plan. Aside from understanding the basics of NQSOs, it may be interesting to note that 11% of ALL stock options expire because the employee forgot about them! Working with a knowledgeable financial advisor to assist with the tracking and analysis of your equity compensation could minimize this statistic.

INCENTIVE STOCK OPTIONS (ISO)

Incentive stock options (ISOs) operate like nonqualified stock options but provide a favorable tax treatment. Incentive stock options are not taxed at the grant, vesting, or exercise dates. If the qualifying disposition is met, then taxes are deferred until the stock is sold and qualify to be taxed at the more favorable capital gains rate. To meet the qualifying disposition requirements the stock must be held:

- for at least 1 year upon exercise, and
- 2 years from grant date

If the qualifying disposition is not met, then ordinary income taxes will be owed on the difference between the fair market value and exercise price. Although tax is not typically owed at exercise of an ISO, there is a potential tax consequence in that the bargain element (difference between grant price and fair market value) is an AMT (alternative minimum tax) preference item which means an addition to income for the AMT calculation. This additional 'phantom' income can create an unexpected tax bill. The decision to exercise an ISO should be carefully evaluated with your advisor and your CPA to manage the tax consequences.

EMPLOYEE STOCK PURCHASE PLAN (ESPP)

An ESPP is offered as an employee benefit where a participating employee can purchase company stock at a discounted rate (typically between 5%-15%) via after-tax payroll deductions. The employee is taxed on the discount at each purchase – this is automatically processed through the employee's payroll system. The benefit of buying company stock through the ESPP is to purchase shares at a discount with the potential for the value of the stock to grow and receive taxation at long term capital gains rates, if the one-year holding period is met. One consideration to keep in mind is the possibility for over concentration in one stock. The ESPP plan contribution percentage and subsequent sales should be carefully evaluated and considered within the framework of a well-diversified portfolio.

KEY TAKEAWAYS

Equity compensation is an important source of income and a significant future asset. Due to the complex rules surrounding equity compensation, a lack of proper planning can result in loss of compensation, excess taxes, and a chance of missing out on significant tax advantages. Additionally, reporting on equity compensation is different than traditional brokerage accounts. This requires careful understanding and proper handling when filing the tax return. Choosing how to manage equity compensation is dependent on the specific rules of the plan, a person's current tax liability, available liquidity, potential employment termination, and much more. Equity compensation is a part of your overall financial plan and opportunities should also be considered for possible integration with a charitable gifting plan as well as an estate plan. If you are a recipient of equity compensation, we recommend exploring all available strategies with your financial advisor and CPA to maximize your benefits.

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