Equity-Based Compensation

As you grow within an organization, equity-based compensation can often become a greater percentage of your total compensation and in turn your overall net worth. This can result in a significant portion of your net worth being tied to a single stock. There are several different forms of equity compensation, each with their own set of rewards, risks and tax consequences. As a result, it is important to have a financial plan that considers each of these factors and coordinates your equity compensation with your long-term financial goals. Here is a look at some of the most common types of equity compensation plans.

NON-QUALIFIED STOCK OPTIONS

Non-qualified stock options (NQSOs) give you the right to buy a certain number of company shares at a specified price (known as the strike price) during a set window of time. Typically, your right cannot be exercised until you have satisfied the vesting requirements set forth by the company. Vesting schedules vary but are often performance based, time based, or both. Additionally, vesting schedules can be on a cliff (all shares vest at the same time) or graded schedule (a percentage of the eligible shares vest each year).

Once the NQSOs vest, you can exercise your shares, but you are not required to do so. This gives you some flexibility as you can control the timing of the exercise and thus when the taxes from the options are triggered. Keep in mind that if you don't exercise your options before the expiration date, they will expire worthless, even if the stock price is higher than the grant price. The most common term is 10 years from the date of grant.

When you exercise your options, typically you will recognize compensation income based on the difference between the fair market value of the shares at the time you exercise the option and the strike price. This income will be subject to federal, Social Security, Medicare and any applicable state and local income tax. The most common exercise method is a cashless exercise. With this type of exercise, you can exercise and sell a portion of your shares to cover the option cost and taxes owed resulting in no cash outflow. However, you also may be able to simply pay cash. Once you sell your shares, you will then recognize either a short or long-term capital gain or loss depending on how long you owned the shares post-exercise. Keep in mind that your cost basis is generally equal to the exercise price plus the ordinary income recognized.

INCENTIVE STOCK OPTIONS

Incentive stock options (ISOs) are similar to NQSOs. ISOs allow you to purchase a specific number of company shares for a set price at a later date. As with NQSOs, there are no tax consequences when you are granted your options under regular or AMT rules. ISOs also usually contain a vesting schedule that must be satisfied before you can exercise the options. Once vested, you can then exercise the options up to the expiration date which cannot exceed 10 years.

Unlike NQSO, you do not recognize compensation income upon the exercise. However, the difference between the fair market value of the shares and exercise price is an alternative minimum tax (AMT) adjustment. Keep in mind that if you are exercising a significant number of ISOs the adjustment can be large enough to cause an AMT consequence. If the stock is then sold within one year from the date of exercise or two years from the date of grant, the difference between the fair market value of the stock on the exercise date and exercise price is considered ordinary income. The remainder is capital gain. Alternatively, if the stock is sold one year from the date of exercise and two years from the date of grant, the gain is a long-term capital gain.

RESTRICTED STOCK UNITS

A restricted stock unit (RSU) is a promise from your employer to grant you shares of the company stock in the future if certain restrictions are met. Each grant of RSUs typically has its own vesting schedule. Once the RSUs vest, you will then recognize compensation income based on the fair market value of the shares on the vesting date. This income will be subject to federal, Social Security, Medicare and any state and local income tax. Unlike stock options, your RSUs will almost always have an intrinsic value; whether the value of the company stock increases or decreases they will be worth something as long as the stock price is higher than $0.

Many companies offer various options for paying the taxes due at vesting. The most common practice is to surrender a portion of the newly vested shares to cover the taxes before distributing the remaining shares to you. However, you may also have the option to use cash or sell part of your shares and use the proceeds to cover the withholding. Keep in mind that companies often withhold a flat tax rate so the withholding may not be enough to cover your tax liability.

Depending on your outlook for the company and financial situation, you may then decide to sell or hold your RSUs. If you choose to sell them immediately, there will likely be no tax consequences. However, if you hold onto the shares, then the difference between the sales price and vest price will be taxed as either a short or long-term capital gain/loss when you sell the shares. It is also important to point out that RSUs do not expire unlike stock options.

EMPLOYEE STOCK PURCHASE PLANS

Employee stock purchase plans (ESPPs) give you the right to purchase company stock, often through after-tax payroll deductions, at a discounted price. Most companies set the discount between 10% and 15%. Once ESPP shares have been purchased, you can then sell them at your discretion—unlike stock options and RSUs which are often subject to vesting schedules.

Typically, there are no tax consequences on the date of grant or exercise. Taxes are only due when the ESPP shares are sold. Depending on when you sell the shares, the disposition will either be considered qualified or nonqualified. If you dispose of the ESPP shares in a qualifying disposition (a sale more than two years from the grant of the option and one year after the exercise), you will recognize ordinary income based on the lesser of the fair market value of the stock on the grant date less the option price or fair market value of the stock on the disposition date less the option price. The excess, if any, will be treated as a capital gain.

Alternatively, if you dispose of the ESPP shares in a disqualifying disposition (a sale within two years from the grant of the option or one year after exercise) you will recognize ordinary income based on the difference between the fair market value of the stock on the exercise date less the option price. The balance is then treated as a capital gain. It is also important to note that your basis would generally be the amount paid for the stock plus the amount included in income regardless of whether it is a qualifying or disqualifying disposition.

WE CAN HELP

Equity based compensation plans can be a powerful tool for accumulating wealth and can play a significant role in your overall financial picture. However, there are often diversification, liquidity and tax issues related to such plans that create unique financial planning needs. Our team of professionals can help you navigate the financial complexities involved with your equity compensation in conjunction with your overall financial plan to help you make sound financial decisions and achieve your long-term goals.