TAILORED WEALTH

WHEN EQUITY COMPENSATION IS PART OF YOUR PACKAGE

YOUR GUIDE TO STOCK OPTIONS, RESTRICTED STOCK UNITS, EMPLOYEE STOCK PURCHASE PLANS, AND EMPLOYEE STOCK OWNERSHIP PLANS

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If you've recently changed jobs or you're weighing a new job offer, there's a good chance your package will include equity compensation.

About one-third of private companies and 40 percent of public companies offer this perk, and it's no longer reserved just for executive-level positions.

With lots of companies still struggling to compete for top talent (yes, even in the tech sector!), equity compensation helps employers in two ways: It sweetens the pot to get you in the door and provides a strong incentive to keep you there longer. If the company performs well and the stock value rises, you can reap quite a reward.

Whether you're working for or thinking about joining a tech startup, a mature public company, or anything in between, equity compensation can prove a nice opportunity to build your portfolio by owning a slice of your company. But for all its advantages, equity compensation is complex—and not without risk.

That's why we created this guide! It can help you make sense of the equity compensation included in your current package or give you greater knowledge (and power) when negotiating any job offers on the table. We cover the five most common types of equity compensation, including how they work and their tax implications, along with the risks associated with equity compensation and how they fit into your overall financial picture.

Let's dive right in!

1. Incentive Stock Options (ISOs)

If you receive incentive stock options (ISOs), it means you have the opportunity to buy a certain number of shares of your company's stock at a pre-determined price, called the strike or grant price. You exercise the options by buying them at the grant price. At that point, those shares are yours to hold or sell as you choose.

But you won't receive all the granted ISOs upfront. There's usually a vesting schedule that spans at least a few years (remember what we said about companies using equity comp to keep you on board longer?). Some companies use a graded schedule (e.g., 25% of the options vest every year for four years). Others use a cliff schedule (e.g., 100% of the options vest after three years). You're not required to exercise them as they vest, but they typically expire at some point—so read the fine print to avoid leaving ISOs on the table inadvertently!

What to Consider:

Do you want to exercise your ISOs?
Since a stock option is just that—the option, but not the requirement, to buy shares of your company's stock—you need to consider whether to exercise them as they vest. Hopefully the stock price rises beyond the initial grant price, so you can sell your shares at a gain. But of course, the stock market can be volatile, especially over short periods, so there's no guarantee the stock will be worth more than what it cost you to buy. If the shares never trade for higher than the price you pay to exercise them, you won't realize any gain.

What happens when you leave?
When it's time to move on from your current job, you might have vested options you haven't exercised yet. Find out if your employer will let you exercise them after you leave, which some companies allow.

1.1 The Tax Implications

ISOs are taxed very favorably—as long as you follow two key rules:
If you hold the shares for at least one year from the date you exercise the options AND at least two years from the date the options were granted, you'll pay tax on the gain at your long-term capital gains rate. Right now, those rates are pretty sweet! But if you don't meet both requirements, you'll pay tax on the gain at your ordinary income tax rate (which is likely higher).

There's just one caveat:
When you exercise ISOs by purchasing shares, you could trigger the dreaded alternative minimum tax (AMT). The AMT is complicated, and there's no simple rule for avoiding it. Before you exercise ISOs, talk with your financial planner or accountant to avoid an unpleasant AMT surprise.

A Typical ISO Transaction

1. GRANT & VESTING

The company grants you:
10,000 ISOs
At a grant price of:
$12/share
On a vesting schedule of:
Five years, with 20% of the options vesting each year

2. EXERCISE

After one year:
You exercise 2,000 options (the vested amount)
You pay:
$24,000 (2,000 shares x the grant price of $12/share)

3. SELL

Two years later:
The stock's market value is $25/share
You sell:
All 2,000 vested shares at the market price of $25/share, receiving $50,000

4. TAX CONSIDERATIONS

Your taxable gain is:
$26,000 ($50,000 minus your $24,000 cost basis)
Your tax liability is:
$26,000 x your long-term capital gains rate

* Examples are hypothetical and for illustrative purposes only. Your benefits will vary.

2. Nonqualified Stock Options (NSOs)

Much like ISOs, nonqualified stock options (NSOs) give you the opportunity to buy shares of your company's stock at a predetermined price, with the options usually subject to a vesting schedule and an expiration date.
But NSOs differ from ISOs in two important ways:

- The grant price is typically the same as the market price at the time the company grants you the options. You don't receive a "discount" when you exercise them, the way you do with ISOs.

- You don't get very favorable tax treatment with NSOs (as explained below). On the flip side, that gives you a little more flexibility in deciding when to sell the shares.

Since ISOs and NSOs work very differently, if a prospective employer is talking about granting you "stock options" it's important to know what type of options they mean!

What to Consider:

Do you want to exercise your NSOs?
You're not obligated to exercise them, so give careful thought before you do. Since the grant price is the same as the market price at the time the company grants the options, the stock price will need to appreciate to make those shares worth anything right out of the gate. Of course, stock investing is a long-term play, but the fact that your NSOs were granted at fair market value definitely factors into the equation.

Do your NSOs expire when you leave?
Before ending your employment, check whether you're allowed to exercise vested NSOs after you leave. Some companies allow it up to 90 days after your departure.

2.1 The Tax Implications

NSOs trigger a tax liability at two different times (so be sure you're ready for the tax bill):

- When you exercise the options. The difference between the grant price and the market price at the time you exercise your NSOs is considered earned income—ouch! You'll owe tax on that amount just as you would any other earned income, including federal tax, payroll tax (Social Security and Medicare), and any state and local tax you're subject to.

- When you sell the shares. Any gain you realize on your NSOs—the difference between what you pay for them and their market value when you sell them—is also taxable. If you hold the shares for at least one year, you'll pay tax on the gain at your long-term capital gains rate. If you sell them sooner, you'll get dinged for the higher ordinary income tax rate.

A Typical **NSO** Transaction

1. GRANT & VESTING

The company grants you:
8,000 NSOs
At a grant price of:
$18/share
On a vesting schedule of:
Four years, with 25% of the options vesting each year

2. EXERCISE

After one year:
You exercise 2,000 options (the vested amount)
You pay:
$36,000 (2,000 shares x the grant price of $18/share)
Your tax liability is:
The amount of federal, payroll, state, and local tax you would owe on the difference between the grant price and the fair market value of the shares you exercised

3. SELL

Three years later:
The stock's market value is $28/share
You sell:
All 2,000 vested shares at the market price of $28/share, receiving $56,000
Your taxable gain is:
$20,000 ($56,000 minus your $36,000 cost basis)
Your tax liability is:
$20,000 x your long-term capital gains rate

* Examples are hypothetical and for illustrative purposes only. Your benefits will vary.

3. Restricted Stock Units (RSUs)

Unlike stock options, RSUs are actual shares of stock the company gives you directly. You don't need to pay anything or take any action to receive them, and they're worth their fair market value on the date you get them. That means they have immediate worth to you, whether the stock price goes up or down later.

Like stock options, RSUs are usually subject to a vesting schedule to keep you motivated to stick around. But sometimes, that vesting schedule isn't just based on your years with the company; it might involve other triggers based on company performance

What to Consider:

Your RSUs might not be guaranteed money.
If the vesting schedule requires the company to hit certain milestones to trigger each set of RSUs, it's possible you won't receive all the RSUs specified in your offer. Before you start counting your money, be sure you know what the vesting is based on!

There's almost no risk to you.
You're receiving shares without having to pay for them, other than the initial tax hit (explained below). Unless the stock's market value drops below the amount of tax you paid when you first received the shares, it would be tough to lose money on RSUs.

There could be a cliff schedule.
With a cliff, all your RSUs vest at once, usually after a few years. So they're only valuable to you if you stay past that one vesting date. It's an all-or-nothing proposition.

3.1 The Tax Implications

Even though you don't have to pay to purchase RSUs, they're not truly free. Uncle Sam will take a cut at two different times:

- When you receive RSUs. The fair market value of your shares when they vest is considered earned income. Yes, that means you'll owe federal, payroll, state, and local tax on the value. If you're fortunate to receive a lot of RSUs, this initial tax hit could be steep! Fortunately, most companies withhold 20 percent of the shares' value to cover some of the tax. But it's unlikely to be enough, so plan ahead on how to cover the rest.

- When you sell the shares. As with any stock sale, you'll owe tax on any gain you realize when you sell. Hold them for one year from the date they vest and you'll pay the more favorable long-term capital gains rate; sell them sooner and you'll pay the short-term capital gains rate (your ordinary income tax rate).

A Typical **RSU** Transaction

1. GRANT & VESTING

The company grants you:
12,000 RSUs
On a vesting schedule of:
Five years, with 20% of the units vesting each year

2. EXERCISE

After one year:
You automatically receive 2,400 shares (the vested amount), which are trading at $20/share
You pay:
Nothing to buy the shares since they're given to you directly
The stock's value is:
$48,000 (2,400 shares x the fair market value of $20/share)
Your tax liability is:
The amount of federal, payroll, state, and local tax you would owe on $48,000 of earned income

3. SELL

Two years later:
The stock's market value is $32/share
You sell:
All 2,400 vested shares at the market price of $32/share, receiving $76,800
Your taxable gain is:
28,800 ($76,800 minus your $48,000 cost basis)
Your tax liability is:
$28,800 x your long-term capital gains rate

* Examples are hypothetical and for illustrative purposes only. Your benefits will vary.

4.Employee Stock Purchase Plans (ESPPs)

If you're eligible to participate in your company's employee stock purchase plan (ESPP), you can buy its stock at a discount that usually ranges from 5 to 15 percent off the fair market value. If you own more than a certain percentage of the company's stock, you're typically excluded from participating. For everyone else, there's usually a waiting period before you can enroll.

What to Consider:

An ESPP keeps you investing regularly.
You make contributions through payroll deductions, so it's a nice set-it-and-forget-it way to keep investing and building wealth.

There's a lag in your stock purchases.
The company schedules certain dates that employees can buy shares at the discounted price using the funds they've accumulated through payroll deductions. So, even though the money comes out of your paycheck right away, you won't own the stock until you buy it on those specified purchase dates.

An ESPP still requires due diligence.
Just as you'd research any company before buying its stock, always do your homework before enrolling in an ESPP. Ask yourself, "If I wasn't an employee of this company, would I still buy the stock?"

4.1 The Tax Implications

From a tax perspective, the shares you buy through an ESPP work no differently than the shares you would buy through a brokerage firm.

When you sell the shares, you pay tax on any gain—the difference between what you paid for the shares and their market value on the day you sell them. If you hold them for at least one year, you'll pay the long-term capital gains rate; if you sell sooner, you'll pay the short-term capital gains rate. So, while you might be tempted to immediately flip your shares and sell them at a profit (since you bought them at a discount), the higher short-term capital gains rate will erode some of your gain.

5.Equity Stock Ownership Plans (ESOPs)

Your compensation package also might include an employee stock ownership plan (ESOP), especially if you work for a privately held company. And though the name sounds similar to an ESPP, this type of plan works much differently.

An ESOP is a defined-benefit retirement plan. But unlike other defined benefit retirement plans, like a 401k, and unlike an ESPP, you don't contribute to an ESOP. Instead, the company fully funds the plan on your behalf. This form of equity compensation offers some good tax advantages (described below), so it can make a nice addition to your retirement portfolio.

What to Consider:

There's usually a vesting schedule.
Since an ESOP is intended to offer a financial incentive to stay with the company, the shares you earn typically vest over a period of at least a few years.

Participation isn't open to everyone.
The criteria for eligibility might include certain pay bands within the company or a certain length of tenure.

Withdrawals are subject to RMDs.
Just like you must take required minimum distributions (RMDs) from a 401k once you reach a certain age, you're required to take RMDs from an ESOP. (The age thresholds changed recently, so talk with your financial advisor for details!)

Any accumulated funds are distributed when you leave.
But you typically have multiple options for what to do with the funds, like rolling them into another retirement account. Companies usually pay out the value of your stock as shares, cash, or a combination.

4.1 The Tax Implications

- The company's contributions aren't taxed. Much like the matching contributions your employer makes to your 401k plan, their ESOP contributions are not considered taxable income for you.
- Your withdrawals are taxed. Similar to a 401k, when you withdraw funds from an ESOP you pay tax on the total withdrawn amount at your ordinary income tax rate. Until then, the value of the plan grows tax deferred! But think twice before taking funds out prior to turning 59½, since early withdrawals come with a hefty 10 percent penalty.

How Equity Compensation Factors into Your Financial Plan

Equity compensation can help you build wealth, sometimes with more favorable tax treatment, but it's not all reward and no risk. If equity compensation is part of your package, you need to understand how it affects your total portfolio and your overall financial plan.

Here are some key things to consider:

- Are you staying diversified enough? You probably wouldn't want any single company to make up the lion's share of your portfolio. But that's a real possibility if you have a lot of equity comp. The more your assets are concentrated in your company's stock, the greater your risk. Especially when you consider that you now have a lot of wealth tied up in the same company you depend on for your salary and benefits! How much concentration is too much? That depends on a lot of factors, including the size of your total portfolio, your tolerance for risk, and your investing horizon. It's a complex decision, so you'll want an experienced financial planner to guide you.

- Are you staying unemotional? It's great to feel passionate about what your company does and confident in its future—unless that passion begins to affect your financial decisions. When it comes to investing, emotions are rarely a good thing. You need to make informed decisions about if and when to exercise your options, sell your shares, or invest in an ESPP, based on rational facts, not emotions. Working with a qualified financial planner can help you keep emotions from ruling your decisions.

- Are you looking at the total picture? Employees often look at their equity compensation in a vacuum. But the current and potential value of your equity comp is part of your total financial picture. And there's no right-or-wrong answer on how to manage it. Instead, think about your life goals, financial goals, and career objectives and decide how your equity compensation can support them.

- Are you negotiating a win-win? If you're evaluating a new job offer and you think there's room to negotiate, look beyond the base salary. You'll find some companies can be more flexible with equity comp than they can with your salary. The best outcomes align the company's objectives and yours, so find that common ground and you'll end up ahead!

How Tailored Cents Can Help

Equity compensation can be complex to navigate, unless you partner with a financial planner that has deep knowledge and expertise in this area.

That's Tailored Cents!

The Tailored Cents team regularly works with professionals who've recently made a job change or are about to embark on a job search—especially professionals in the tech sector. We know the ins and outs of stock options, restricted stock units, employee stock purchase plans, and employee stock ownership plans, including how they can help you build wealth, the tax implications, and the risks to avoid.

A Tailored Cents financial planner can:

- Evaluate how your equity compensation affects your total portfolio and overall financial picture—both now and over time
- Help you stay diversified even as the value of your options or shares increase (a great problem to have!)
- Advise you on key decisions like when to exercise options or sell shares, based on highly personalized factors like your life goals, financial objectives, total portfolio value, risk tolerance, and others
- Recommend strategies for addressing the tax liability you'll face when exercising options, receiving stock units, selling shares, or withdrawing from an ESOP
- Help you make rational, fact-based decisions about your equity compensation and keep emotions from taking control

By providing virtual financial advice and planning that's tailored to your individual needs, Tailored Cents focuses on helping you achieve your goals, at every stage of life.

Have questions about the equity compensation in your new package?

Schedule a call with a Tailored Cents financial planner to learn how we can help!

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