

WHAT IS EMPLOYER STOCK COMPENSATION?

Attracting good talent starts with an excellent compensation package. In addition to competitive salaries and robust benefit offerings, some employers may offer stock as a form of equity compensation. Stock options are designed to motivate corporate leaders to boost stock values and build companies that will thrive over the long run. Employer stock and options can offer great upside rewards but, if you're unsure what to do with them, it could be a missed opportunity to boost your wealth.

Whether you're considering a new role or already established with an employer that offers equity compensation, it benefits you to understand the ins and outs of these agreements and to develop a strategy aligned with your financial goals.

Restricted Stock Units (RSU) and How They Work

Restricted stock units, also known as letter stock, restricted securities, or RSUs are one form of equity compensation. Employers usually offer RSUs to incentivize employees to stay with the company and help it grow. This is because if the employee helps increase the company's value, their shares will increase in value.

With RSUs, the company grants you stock after certain restrictions are met. Usually, RSUs are subject to a vesting schedule, which means you won't own the shares until they are vested. For example, let's say you are hired by a company that offers a signing bonus of 50,000 RSUs in addition to your salary and other benefits. The company sets up a vesting schedule which makes 10,000 shares available to you each year, over five years. Every year more shares will vest, at which point they are no longer restricted, and you can sell or hold them as you see fit.

Tax Implications of RSUs

When you earn income, typically you expect some amount of tax to be paid to the government. Since RSUs are a form of compensation through equity, they are treated similarly as your salary or wages for tax purposes.

When RSUs become vested, an amount equal to the fair market of these newly unrestricted shares will be added to your taxable income for that year.

RSUs are subject to ordinary income taxes at the Federal, and State level. Even if you don't sell your shares, you must pay taxes based upon the fair market value at the time when your shares vest.

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This same fair market value at the time shares vest is your cost basis. If you decide to hold the shares and they increase in value, when you eventually sell shares, the difference between the cost basis and the amount you sold the shares for will be subject to capital gains tax.

There are three options to pay taxes once the stock vests:



Same-day sale of all stock = All unrestricted shares are sold, you receive the cash left over after subtracting tax withholdings..



Sell to cover = Just enough unrestricted shares are sold to cover the tax withholding. You keep the remaining shares and can sell them whenever you want. This is often the default action by an employer.



Cash transfer = The employee covers the required tax withholding amount with cash. If you pay the amount in cash to cover withholding, then all of the shares belong to you.

Risk and Reward of 83(b) Election

If you made an IRC section 83(b) election, you will be taxed on the fair market value at the time of granting and will have withholding at the time the stock is transferred to you.

Making an 83(b) election is a big risk, but it can pay off. With an 83(b) election you pay taxes on the value of the RSUs at the time they are granted.

If the stock price is lower on the vesting date or when you sell shares, you've already paid taxes on the higher amount from when the RSUs were originally granted. An 83(b) election can be beneficial in the event the value of the stock goes up considerably between the time your RSUs were granted, vested, and sold.

Employer Stock Options and How They Work

Another popular form of equity compensation are employer stock options. With stock options, you have the "option" to buy a specific number of shares at a certain price per share, known as the strike price or exercise price.

With options, your employer allows you to choose when to exercise this opportunity if it falls within the allotted time. You may also be subject to a vesting schedule or black out period, before you can exercise your stock options.

Many factors such as taxation, market value, and market conditions can influence your decision on exercising stock options.

RSUs vs. Employer Stock Options

At first glance, employer stock options and RSUs seem one and the same. But that’s simply not the case. With employer stock options, the company grants you the ability to buy shares of its stock at a specific price. You have a choice to buy the stock, or not, at the agreed price before the expiration date. Whereas with RSUs, the company grants you stock, and once vested it’s yours, you don’t have to purchase anything.

	Stock Options	RSUs
Exercise Price	Determined by stated price in option agreement	No exercise price
Vesting	Usually awarded on a set vesting schedule	Can be awarded on set vesting schedule or performance benchmarks
Payment	Cash exercise, cashless exercise, stock swap	No payment required
Taxation	Taxed upon exercise and/or sale	Taxed upon vesting
Common Uses	Popular with early or mid-stage start-ups	Popular with late-stage start-ups and public companies

Types of Stock Options

There are two main types of employer stock options; they are nonqualified stock options (NSO) and qualified stock options (ISO). Familiarizing yourself with which stock options are included in your equity compensation agreement is crucial.

NSOs and ISOs have different benefits and tax implications. It’s important to understand these key differences so you can make informed decision when exercising your options.

NONQUALIFIED STOCK OPTIONS (NSO)

Nonqualified stock options, also known as non-statutory options, or NSOs, are taxed at your ordinary income tax rate when you exercise the option. Upon exercising these options, you will receive shares of stock.

The cost basis of the stock is equal to your exercise price, which is what you paid per share to acquire it.

Companies may grant NSOs to employees, consultants, service providers, and other insiders.

INCENTIVE STOCK OPTIONS (ISO)

Qualified stock options, also known as incentive stock options, or ISOs, can qualify for special tax treatment if you play by the rules. To qualify for the tax advantages of ISOs you need to wait to sell the stock until at least two full years from the ISO grant date, and one full year from the exercise date. This is called a qualifying disposition; it is the most tax efficient strategy for dealing with these types of stock options.

In addition, ISOs are reserved exclusively for company employees and insiders.

Exercising Your Stock Options

When you exercise stock options, you have the right to purchase a certain number of shares per the stock option grant. Therefore, it only makes sense to consider exercising your options when the current share price is higher than the exercise price.

For example, let's assume you have stock options with an exercise price of \$100 per share. If you exercise your stock options when the market value is \$180 per share, you can purchase the stock for \$100 per share and immediately have an unrealized gain of \$80 per share.

The difference in price between the exercise price and the share price when you exercise is called the bargain element. The bargain element may or may not be immediately subject to taxes depending on the type of stock option you exercised.



Most option grants will have an expiration date, typically up to ten years. If you're planning on leaving your employer, check your stock option agreement to verify if any terms will change upon your departure. Look for the post-termination exercise period in the agreement. Separation from service can affect vesting and expiration dates, plan accordingly.

These are some of the most common reasons to consider exercising stock options:

- You think your company's shares will decrease in value, and you want to sell your shares before this occurs.
- Your portfolio is too heavily weighted in your company's stock. Therefore, you need to sell to diversify your investment portfolio and reduce risk.
- Selling your stock options all at once would move you up to a higher tax bracket. Therefore, you want to sell shares over time to potentially reduce the tax burden.
- You think the company stock is an excellent investment, so you want to accumulate as many shares as possible before the market value increases.

Strategies for Exercising Stock Options

When you exercise your stock options, three main strategies are worth considering. Review your options agreement to determine which of these strategies may be available to you and if other restrictions apply.

- 1 Cash exercise, hold your shares. One strategy is to purchase your shares with cash and then hold them, this is called a cash exercise. Holding your shares allows you to invest further in your company and the opportunity for potential gains if the stock value increases. You may also receive dividend payments from owning the stock, if applicable. For a cash exercise you will need to transfer cash or borrow on margin to buy the shares, other fees and taxes may apply.
- 2 Cashless exercise, sell your shares. If you want to make an immediate profit, selling your shares is a strategy worth considering. Usually, you don't need to use cash for the transaction. Instead, the proceeds from the sale of the shares can cover the purchase price and any expenses involved with exercising your options. Using this strategy allows you to diversify or spend the proceeds as you please. You could also choose a cashless exercise and still hold the net amount of shares for the future.
- 3 Choose a stock swap. With a stock swap, you exchange company shares already in your possession worth an amount equal to the cost of exercising your options. This eliminates the need for cash to exercise the options, however you may still be required to pay tax withholding directly if you choose to do this. This strategy may be beneficial for someone that already has company stock.

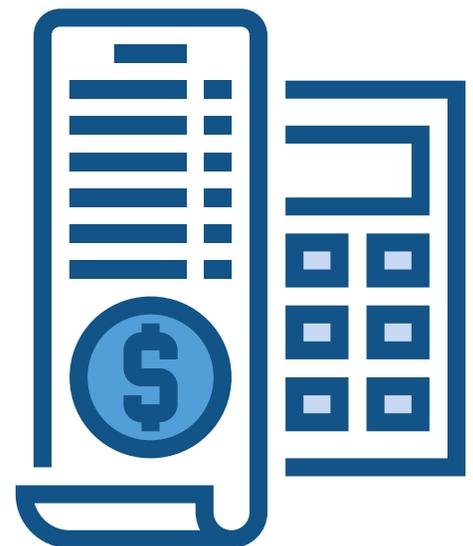
Tax Implications of Exercising Your Stock Options

Probably one of the most confusing things surrounding stock options are the tax implications and rules which apply differently to NSOs and ISOs. One important similarity is that you are not taxed on stock options when they become vested, but rather when you exercise or sell stock.

When exercising NSOs you are taxed on the bargain element, which is the difference between the exercise price and fair market value price of the stock when you exercise. This amount is subject to ordinary income tax.

With NSOs your cost basis is the total fair market value of stock received after exercising the option.

With ISOs it's possible you may not owe any taxes at the time of exercising, unless you decide to sell some of the stock, this includes a cashless exercise. ISO stock options are subject to capital gains tax on the difference between the exercise price and the fair market value share price of the stock when you sell it.



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With ISOs your cost basis is the total cost of exercising the option.

There is a capital gain if the total proceeds from selling stock is higher than the cost basis. Long term capital gains tax rates apply if you hold the stock for at least one year before selling it. Short term capital gains tax rates apply if held less than one year.

Tax considerations for NSOs and ISOs are drastically different, and your employer may be required to withhold some amount of estimated taxes when you exercise your options.

One more thing to consider is that ISOs are subject to an alternative minimum tax, or AMT. This makes the potential taxation of ISOs even more complex. AMT is a minimum tax rate to ensure that high earners pay at least a minimum amount of tax, regardless of deductions.

Consider consulting with a tax professional and financial planner to fully understand how NSOs, ISOs, and if AMT factors into your tax and financial situation.

Tax Reporting for Restricted Stock and Stock Options

When RSUs vest or you exercise NSO and ISO stock options, your employer is responsible for certain types of tax reporting. Your employer or the financial company transacting the shares may also be required to withhold for taxes.

Compensation from RSUs are reported on your W2 and IRS form 1099-B. Stock options are reported on IRS form 3921 and 3922. These forms can help you determine cost basis, gains or losses and if any amount is subject to ordinary income tax.

Stock options and RSUs can provide a platform for building wealth. But, mismanaging them can put you in a challenging financial situation. The best course of action is establishing a plan so you can make smart decisions and avoid costly mistakes.

With this in mind, here is a list of the most common pitfalls when dealing with restricted stock and stock options.

NOT UNDERSTANDING EMPLOYER STOCK COMPENSATION AND INCENTIVES

While this may not come as a surprise, many employees don't read the fine print of their stock plan agreements. So, before you do anything else, take a moment to review these documents and familiarize yourself with the type of grants you received and applicable rules.

NOT EXERCISING STOCK OPTIONS BEFORE EXPIRATION DATE

Stock options have an expiration date, and this date may be adjusted in the event you separate from service. This means that if you wait until after the expiration date, your stock options cannot be exercised, effectively rendering them worthless. Pinpointing a timeline can help you make a plan, so you're not scrambling to exercise your shares at the last minute.

NOT PLANNING FOR STOCK PLAN RELATED TAXES

Before deciding how and when to exercise your stock options, you must understand each decision's tax implications. Taxes can impact the profitability of stock options. It's possible the stock price moves downward quickly, and you may be forced to sell stock at a loss in order to cover tax obligations in the future.

However, taxes alone shouldn't drive your decision making. It would help to align your strategy for dealing with employer stock with your financial goals and objectives. It's wise to model tax situations so you can prepare in advance. For example, often, employers don't withhold enough taxes when you exercise your options. Consider setting aside additional funds to pay your remaining tax bill.

RSUs and stock options can potentially bump you into a higher tax bracket. So, carefully timing your stock plan execution and disposition plan may help you avoid unnecessary tax increases.

HOLDING TOO MUCH OF YOUR NET WORTH IN EMPLOYER STOCK

You may have a personal connection with your company's stock as an employee. You believe in your work and your mission, so you're optimistic about the stock value climbing the longer you hold onto it. It may also be that over your entire tenure it only seems the stock price of your company continues to climb.

Regardless of the size or success of a company, it presents more risk to your overall financial situation if you choose to hold a higher percentage of your net worth concentrated in one stock.

It's possible that one day, having too much of your portfolio tied up in your company's stock may become more of a curse than a blessing.

Consider diversifying across different investments and asset classes over time. After all, it's unlikely that a single company will outperform all other investments consistently over time.

While your company might not see a total collapse in share value, economic and market events can impact a single stock more than others. Your portfolio and income could see significant fluctuations that make it challenging to plan for your future.

NOT UNDERSTANDING WHAT HAPPENS TO YOUR SHARES WHEN THE COMPANY GETS ACQUIRED

It's possible your company may get acquired. So, where does an acquisition leave your restricted stock and stock options? Well, it depends on the negotiations between both companies during the acquisition. Some outcomes may include:

- Immediately vest all RSUs
- Shorten the vesting schedule and expiration date, therefore you must exercise your stock options all at once
- Substitute your stock options for a cashless exercise
- Exchange stock option shares for shares of the company acquiring your company
- Receive a combination of cash and stock with a new vesting schedule
- Receive a cash payout for all of your vested and unvested option or shares

No matter which option your employer goes with, it's essential to do the research, so you know how to maximize your benefits.

Have Employer Stock Options or Restricted Stock? Here's What to do Next

While employer stock and options can be a huge advantage for your financial success, you want to make sure you make the best decisions to improve your future. Partnering with a fiduciary financial planner at Navalign can help you understand your options and make smart financial decisions that are in your best interest.

We believe every investment decision should align with your personal values and financial goals. Our fiduciary approach ensures that your best interest always comes first.

Do you have questions or ready to make a decision about what to do with your shares? Contact us today to schedule a complimentary consultation to speak with an expert.

