Understanding Equity Compensation

Equity compensation is taking up a larger percentage of income for many employees. Company stock can provide incentives and attract top talent, but it can also lead to significant tax implications and employees can end up taking on too much risk in one security. It is important to understand how these different types of compensation work and how they fit into your financial picture both while you are working and in retirement. We recommend working with both a financial and tax advisor to determine a strategy with that stock that aligns with your long-term financial goals. To speak to a financial or tax advisor at Evergreen, reach out to info@evergreengavekal.com or click here to take our client compatibility survey.

Types of Equity Compensation:

Restricted Stock Awards (RSUs)

Employers can grant stock directly through RSUs, and employees gain access to these shares according to a vesting schedule, typically a percentage of shares vesting quarterly over 3-5 years. The market value of the shares is taxed as ordinary income as they vest. Consult a tax professional to make sure withholding is set up correctly, you can set to have taxes automatically paid for with shares. If shares are held for longer than one year after vesting, they are subject to capital gains when sold. As RSUs can be a large portion of compensation, it is important to create a schedule to diversify shares over time, paying attention to the overall percentage of stock in your portfolio as well as tax implications for selling shares.

Stock Options

Stock options give employees the right to purchase, or exercise, shares at a predetermined price within a fixed period of time. Stock options can provide huge upside for companies whose share prices jump from the time they were granted, but if the stock price falls, options can be worthless. Similar to RSUs, options vest according to a schedule so employees are allowed to exercise the shares over time. There are multiple factors that go into deciding when to exercise options, such as the valuation of the stock, taxes, and risk tolerance.

Incentive Stock Options (ISO)

With ISOs, taxes aren't owed when you exercise your options, but you have to include the difference between the exercise price and the fair market value at exercise in your alternative minimum tax (AMT). AMT can be very significant so it is important to consult a tax advisor before exercising options. ISOs are only taxed at the time of sale, and if held longer than one year after vest and two years after granted, they are subject to long-term capital gains instead of ordinary income.

Non-Qualified Stock Option (NQSO)

These options are less favorable as they are subject to taxation twice, once at exercise and again when the stock is ultimately sold. The difference between the exercise price and the fair market value of the stock is taxed as ordinary income when options are exercised. NQSOs are not subject to AMT.

Employee Stock Purchase Plans (ESPP)

ESPPs allow an employee to purchase company stock at a discount, up to 15% of fair market value. Shares are bought through a payroll deduction. Many employees that have ESPP offered also often have other types of equity compensation, so it is important to review if there is an overconcentration of company stock before purchasing additional shares. We typically recommend no more than 10% of your liquid assets in a single company.

Strategy Considerations

- Many executives often have multiple forms of equity compensation. Review your financial plan and risk tolerance regularly to determine how much should be kept and how much should be invested into a diversified portfolio. A tax advisor can help create a liquidation strategy to manage taxes.
- Be strategic about exercising your options as AMT can be a significant cost. A tax advisor can help create an exercise schedule to help minimize the tax impact.
- Review your holdings periods before selling, as holding for longer than one year and being eligible for capital gains treatment on shares sold can lead to significant tax savings for high earners.
- Are you charitably inclined? Gifting appreciated stock is a very tax-efficient way to give, either directly or through a donor-advised fund.
- Often employees are limited to trading windows. Make note of when you can sell and review your strategy as each window opens.

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