

Equity compensation brings with it potential benefits and pitfalls, both financial and emotional. To make the most of it, it's important to understand how it fits into your broader financial picture now and in the future.

Equity compensation has become a popular way for companies to offer competitive compensation to their employees at a lower cost to them than salaries alone. While equity ownership does bring with it potential benefits to employees, it is important to understand how to make the most of it, especially in instances when equity is structured to be a significant part of your pay package.

The Type of Equity Compensation Makes a Difference

When considering how to manage your equity compensation, you and your advisor will first need to understand the exact type or types of equity compensation you have. Each type brings with it specific limitations and opportunities. When you will actually own shares, how they will be treated for tax purposes and what limitations you may have on purchasing and selling those shares can vary depending on the type of equity compensation. It is also important to understand the specifics of how your equity compensation plan is structured, as each company operates on a different schedule and with different limitations and benefits.

Types of Equity Compensation

- **Restricted Stock Units:**

A promise of shares at a future date (the vesting date) if you meet certain requirements, usually continuing to work at the company and meet performance goals.

- **Restricted Stock Awards:**

Actual shares of stock granted to you, which cannot be sold until they vest, generally according to a vesting schedule or a liquidation event, such as the sale of a company or IPO. RSAs are typically awarded by startups and other early-phase companies.

- **Employee Stock Options:**

The right to buy a set number of company shares at a fixed price (strike price), for a fixed period of time.

Equity Compensation Presents Unique Opportunities and Pitfalls

Equity compensation brings with it both emotional and financial advantages and pitfalls. Having a concentrated position in a single equity creates unique challenges for your portfolio, as the normal volatility of any individual equity can have an outsized impact on your overall financial picture. In particular, companies early in their life cycle, which are often those most inclined to offer generous equity compensation, are also those most inclined to have volatile and potentially idiosyncratic performance. Such behavior typically requires active monitoring and rebalancing to achieve investment goals. In addition to employer stock potentially comprising an outsized portion of your investment portfolio, the same company is typically also signing your paycheck. Would you be financially stable if the company fell on hard times that affected both your investment portfolio and your income?



Equity compensation also presents unique emotional and behavioral challenges. It can be challenging to remain objective about the performance of a company in which you are deeply involved, especially one where you have an ongoing and active role. It can be easy to either overestimate the value of your equity compensation when making financial decisions or, in contrast, underestimate it. Either of these scenarios presents potential problems and leaves open the possibility that you may miss out on opportunities or take on unintended risk.

These considerations underscore the importance of working with a qualified advisor to create a comprehensive financial plan and stick to it. By having a concrete plan, you can avoid the temptation to let emotional attachment to your company skew your judgment and have a clear picture of how equity compensation fits into your portfolio.

Consider Equity Compensation as Part of Your Larger Investment Strategy

Working with your advisor, your first consideration will likely be how much of your portfolio is currently (or will be in the future) concentrated in the one stock you've acquired through your equity compensation package. You'll also want to consider whether that is something that can be changed. With restricted stock units (RSUs), for example, you may develop a long-term plan to sell shares on an ongoing basis as they vest, allowing you to manage your exposure and minimize tax implications. Depending on your situation, your advisor may recommend a 10b5-1 plan, which allows you to set a liquidation schedule in advance, avoiding any potential regulatory issues if you are privy to material non-public information and would otherwise face restrictions on when you can sell shares.

If you hold a concentrated position for a more extended period, such as with restricted stock awards (RSAs) that have limits on sales of shares, you and your advisor will want to develop a plan to help the rest of your portfolio compensate for that exposure and understand long-term options for rebalancing. It is also important to consider your cash needs in the future, as restrictions on shares and tax considerations may limit your ability to sell.

When planning how to handle your equity compensation, also consider what your career plans look like and your likelihood of leaving the company. Typically, leaving the company means forfeiting any unvested shares or unexercised options, so an unexpected job change can significantly impact your portfolio construction if those shares were factored into your long-term plans. Mergers and acquisitions can also alter the vesting schedule of equity compensation, so you'll want to consider the likelihood of the company undergoing an ownership change.

Tax Implications

How your equity compensation is taxed will vary depending on the type and how long it has been since you acquired the shares.

Equity compensation typically can be taxed at two different times. The first is when you initially acquire the possession of shares. This can be at vesting in the case of RSUs or RSAs, or at the time of exercise for stock options. Rarely, without further action such as an 83(b) election, does the income tax impact happen at the time you are granted the shares. A general rule of thumb is that you generate taxable income based on the market value of your shares minus anything you may have paid for the shares.

In the case of vesting RSUs and the exercise of non-qualified options (NSOs), the income will be taxed as wages and your employer may withhold shares to cover taxes. In the case of incentive stock options (ISOs) the exercise may generate AMT income. It is important to work with your financial advisor and a tax professional to appropriately plan for any potential tax liabilities.

We mentioned the 83(b) election. This is a tax election which allows you to be treated as if you receive vested, unrestricted equity or options from an employer, even though the property is subject to restrictions or "a substantial



risk of forfeiture.” Effectively, the election treats an employee who has received stock options or a stock award as having vested immediately, rather than according to the established vesting schedule. This triggers taxation at the time of election, and can provide income tax benefits if the stock appreciates. The election itself starts the longterm capital gains clock, known as the holding period, for applicable equity. It also allows for a lower capital gain tax rate to apply sooner than waiting for equity to vest “naturally” per its schedule. The availability of the election depends on the type of equity and the company’s specific equity compensation plan, and may not be available in all instances. This election is not a risk-free decision and must be done in a timely manner (within 30 days of the transfer of equity). The financial benefit of making such an election can be significant, especially in pre-IPO settings where potential appreciation is high. As always, consider this tax election alongside your advisor and tax professional to make a reasonable determination with your individual circumstances in mind.

The second moment equity compensation could impact your tax situation is at the time of sale. Any gains will typically be subject to capital gains tax. This tax rate varies depending on how long you hold the shares. A sale within 12 months is considered a short-term gain and is taxed as ordinary income, which can be as much as 37% at the federal level, and may increase in the future. In contrast, a sale after 12 months (and at least two years after granting, in the case of ISOs) is considered a long-term capital gain and is taxed at the 20% long term federal capital gain rate. Other taxes and state income tax may also be applicable depending on your situation.

In the event that your stock is considered a Qualified Small Business Stock (QSBS), you may be able to exclude 100% of those gains from federal capital gains taxes or avoid federal taxation on amounts rolled into a new QSBS eligible investment. The QSBS gain exclusion may apply to your stock holding if you have held the shares for at least five years at the time of sale; 75% of the gains if you have held the stock for four years; and 50% of the gains if you have held the stock for at least three years. If you owned QSBS eligible stock before 2025, the tiered benefit for holding less than 5 years did not apply, and instead only the 5 year 100% gain exclusion benefit would apply to those shares. QSBS status is limited to U.S.-based C corporations with gross assets that do not exceed \$75 million (prior to 2025 the rule was \$50 million) at the time of stock issuance (this cap is indexed for inflation) and is only available to companies in certain sectors.

QSBS eligible investments also may qualify for what is called the QSBS rollover. The QSBS rollover allows for the deferral of capital gains taxes when a QSBS eligible investment does not meet the 5 year holding period at the time of sale, the stock was held for at least 6 months, and sale proceeds are reinvested to a new QSBS eligible investment within 60 days of sale. The rollover of those funds to a new investment defers taxes at the time of the first exit and allows you to “tack” your holding period of the old QSBS to the holding period of the new QSBS. When put together, the QSBS rollover to a new investment could allow you to ultimately meet the 5 year holding period for the 100% gain exclusion.

QSBS qualification can materially increase the value of the holdings of emerging company founders and early investors. Issues such as entity choice, capital structure, equity compensation planning and add-on and exit transactions should all be viewed through the lens of QSBS qualification.

Different Stock Options Mean Different Taxes

- **Incentive Stock Options:** Granted only to employees. The difference between your strike price and market price is subject to income tax only if you are subject to the Alternative Minimum Tax (AMT), gains are taxed at time of sale (considered long-term gains if held for more than a year after exercise and for at least two years after granting).



- **Non-Qualified Stock Options:** Granted to employees as well as contractors, investors, and others involved in the company. The difference between your strike price and market price is taxed as ordinary income at exercise, then gains taxed at time of sale (long-term gains if held for more than one year).

Strategies For Employee Stock Options

If you have employee stock options, there are several strategies you could employ to better take advantage of them. The examples below provide some common strategies, but depending on the specifics of your situation, your advisor may recommend additional strategies using tools such as put options or cashless collars.

Buy With Cash and Hold

If you have sufficient liquidity to exercise your stock options and feel confident that the shares will appreciate significantly, you could buy those shares with cash and hold them. This exposes you to the most risk, as it may leave you with a concentrated stock position, but if the shares appreciate at a high rate, it also may provide significant returns.

Holding the shares for longer than 12 months may also provide preferential capital gains tax treatment (and in the case of QSBS, the opportunity to avoid capital gains taxes entirely if the shares are held longer than five years, or partially if held longer than three or four years and if the company meets all other criteria).

Buy and Immediately Sell

If you do not want to take on the risk of potentially building a concentrated position, you could buy the shares and immediately sell them. If the market value of your shares is significantly higher than your cost, this may present an opportunity to realize some immediate gains. However, it does have a potentially high tax cost, as the spread between your strike price and the stock's fair market value would be treated as compensation that is subject to ordinary income tax rates, Medicare tax and possibly Social Security tax. Depending on the situation, you may need to exercise with cash or with some brokerages, you may be able to cover your cost with proceeds from the sale without paying cash upfront via a "cashless" exercise.

Buy and Sell to Cover Cost and Fees

If you do not want to commit cash to the initial purchase of shares, you could buy and sell only enough to cover the cost of your shares and any transaction fees. This may not be available through all brokerages. This leaves you with a less concentrated position but allows you to take advantage of the potential appreciation of those shares.

Wait and See

You may not have the risk tolerance to exercise and hold your company's stock at this time. Alternatively, you may not have the cash upfront to exercise your options and if your company is private, there might not be a market to sell your shares in a "cashless" exercise. In some instances, it may make sense for you to wait until you are more comfortable with the risks, until there is more liquidity to sell your shares or until there is a need to act (e.g., leaving the company or options expiring).

Strategies For Restricted Stock and Profit Participation Units

Strategies for time-based RSUs or performance-based performance stock units (PSUs), which vest only when certain pre-specified financial metrics or operational targets are met, resemble those for stock options with a few key differences.



Hold Long-term

If you feel confident that the shares will appreciate significantly, you could choose to hold them. Similarly to exercising and holding options, this exposes you to the most risk as it potentially leaves you with a concentrated stock position but has the potential to provide significant returns. Holding the shares for longer than 12 months may offer you preferential capital gains tax treatment.

Immediately Sell

Similarly to exercising and selling options, if you do not want to take on the risk of holding a concentrated position, you could sell the shares as soon as possible. Because you don't have any upfront cost, this may present an opportunity to immediately diversify and does not require you to dip into cash reserves to do so. Remember that taxes can be significant if you have held the shares for less than a year.

Use Stock to Fund a Trust or Gift to a Family Member

Rather than selling or holding personally, you could gift the shares to a family member or use them to fund a trust. Bear in mind both the timeline and goals of the trust and the potential tax implications for the family member. If they're likely to want to sell the shares to cover immediate financial needs, they could be facing a significant tax bill. In the instance of RSAs, also remember that this transfer can happen before the shares have vested.

Gift to Your Donor Advised Fund or a Nonprofit

Giving shares to a nonprofit or your donor-advised fund (DAF) is a potentially appealing option to support causes meaningful to you at a minimal upfront cost. In cases where you had already planned to give, it presents an opportunity for you and offers the nonprofit the potential to get more value than you would have given in cash if the shares appreciate. It is important to know your holding period as an appreciated security is provided the full fair market value deduction when the underlying is held for more than a year. If it is held for less than a year then the original cost basis in the property is used for deduction purposes.

Profit Participation Units (PPUs)

Profit Participation Units are a type of synthetic equity compensation. Instead of giving you stock in the company, PPUs tie your potential payout to company performance metrics such as profitability or to a declared profit distribution, eventual sale or IPO. PPUs can't be sold on an exchange and unlike stock options and RSUs the IRS does not have a single taxation framework for PPUs – in some cases payouts are taxed as ordinary income when received and in other cases capital gains treatment applies. So it is critical to consult with a tax professional when PPUs are part of your equity compensation picture.

Conclusion

The complexities of equity compensation underscore the importance of creating a comprehensive financial plan with a trusted advisor. Equity compensation can require ongoing monitoring and rebalancing of your portfolio. The LNW team is here to provide insight and an unbiased view as you navigate your options.



ABOUT THE AUTHORS



Brandon Smith, JD, LL.M. Taxation, serves as a subject matter expert for LNW clients, wealth managers and analysts, helping to identify appropriate tax, trust and estate planning strategies for the unique circumstance of individuals and families with multigenerational wealth. He also works closely with the LNW trust services team on matters pertaining to the firm's trust companies in Washington State and South Dakota and is a member of the South Dakota entity's Board of Directors. An important aspect of Brandon's work is monitoring developments in tax and financial law at the federal and state levels to provide LNW colleagues and clients with proactive analysis and insights.



Steve Herzog, CFP®, has been lucky enough to travel, live, study, volunteer and work professionally in many regions of the world. His clients and our LNW team now have the benefit of the unique perspective he gained working with individuals and corporations in many different circumstances and cultures. Steve advises a wide range of clients including a number of large multi-generational families, partnering closely with them to provide customized portfolio management, diversification strategies for concentrated positions, and advice on tax, trust and estate planning so as to attain their personal, philanthropic and legacy goals.

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