How to Thoughtfully Manage Your Equity Compensation

Leader: *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 is an increasingly common way for companies to offer competitive compensation to their employees at a lower cost to them than salaries alone. While this does bring with it potential benefits to employees, it is important to understand how to make the most of it, especially in instances where you've accepted equity compensation as a way to bring your total compensation to the level you expect.

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 will operate on a different schedule and with different limitations and benefits, even within the same broad type of compensation.

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 but which cannot be sold until they vest, generally according to a vesting schedule or a liquidation event - sale of 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, who are often those most inclined to offer generous equity compensation, are also those most inclined to have volatile and potentially idiosyncratic performance and will require especially active monitoring and rebalancing. 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 either miss out on opportunities or take on unintended risk.

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These considerations underscore the importance of working with your advisor to create a comprehensive financial plan and sticking to it. By having a concrete plan, you can be prepared to 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.

Equity Comp Can Have A Big Impact On Your Financial Picture

Equity compensation requires thoughtful management both because of its value and its implications on your larger financial picture, whether in terms of your portfolio construction, tax considerations or liquidity needs.

Consider Equity Comp as Part of Your Larger Investment Strategy

You and your advisor's first consideration will likely be how much of your portfolio is currently (or will be in the future) concentrated in the one stock which 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 plans, 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.[i]

If you have to hold a concentrated position for a more extended period, for instance, in the case of 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 your long-term options for rebalancing. It is also important to consider what you may need to have available in cash 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 that sort of 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 shares. This can either be at vesting in the case of RSUs, at granting for RSAs, or at the time of exercise for stock options. In each of those cases, the initial tax impact typically happens at the time that you *actually own* the shares, not at the time that you're promised the shares. At this point, you owe income tax on the market value of your shares minus anything you may have paid for the shares. Your employer may withhold shares to cover taxes, so it is best to work with your advisor and a tax professional to plan for any potential tax liabilities.

With RSAs, you have slightly more flexibility, as you can choose to pay income taxes either at granting or vesting. Under section 83(b) of the Internal Revenue Code, you can report the market value of your shares as ordinary income when the shares are granted. In many cases, this can result in much lower tax exposure because the

likelihood is that the value of the shares is lower at the time of granting than in the future when those shares vest.[ii] Bear in mind that there is a risk in this instance. If the shares decrease in value between granting and vesting, or you leave the company before vesting and have to forfeit the shares, you cannot recover the taxes paid on the value that you can no longer realize. It is recommended you work closely with your advisor and accountant to ensure an 83(b) election is properly filed with the Internal Revenue Service (IRS) and your company, as there are tight deadlines that must be followed.

The second time where your equity compensation will impact your tax situation is at the time you sell shares. Any gains will typically be subject to capital gains. This rate varies depending on how long you hold the shares. Sale within twelve 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.[iii] In contrast, sale after twelve months (and at least two years after granting, in the case of Incentive Stock Options) is considered long-term gains and is taxed at no more than 20% for federal taxes.[iv] 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 also be able to exclude up to 100% of those gains from federal capital gains taxes provided that you have held the shares for at least five years at the time of sale.[v] QSBS status is limited to U.S. based C corporations with gross assets that do not exceed $50 million at time of stock issuance and is only available to companies in certain sectors. Your advisor and tax professional can help you to determine if your equity qualifies as a QSBS.

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 be able to 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 twelve months may also provide preferential capital gains tax treatment (and in the case of QSBS, the opportunity to potentially avoid federal capital gains taxes entirely if the shares are held longer than five years and 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 the 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

Strategies for restricted stock units 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 twelve 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.

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, and your LNW team is here to provide insight and an unbiased view as you navigate your options.

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[i] Investopedia. "Rule 10b5-1." January 14, 2022.
[ii] Cooley Go. "What is a Section 83(b) Election and Why Should You File One?" January 23, 2022.
[iii] As of March 2, 2022 for 2021 tax year. Nerdwallet. "2021-2022 Tax Brackets and Federal Income Tax Rates."
[iv] Investopedia. "Long-Term vs. Short-Term Capital Gains: What's the Difference." March 2, 2022.
[v] Investopedia. "Qualified Small Business Stock (QSBS)." June 4, 2021.

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