PROGRESS
WEALTH MANAGEMENT

YOUR GUIDE TO YOUR Equity Compensation

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Equity Compensation

Employee equity can be a satisfying slice of your overall compensation. Sharing in your employer's growth has the potential to be a boon for your long-term financial goals.

Given the rise in popularity of equity as a form of employee compensation – and thus, as a potential portion of your wealth – it's important to know the basics of popular forms of equity compensation.

Your Guide to Equity Compensation will provide high-level education on this form of compensation, including:

- How it fits into your tax strategy
- How it impacts your overall net
- worth How it can help you meet long-term financial goals

"Employee equity can be complicated. With the right information, you can develop a plan to capture profits in a tax-efficient manner."

— Blaine Thiederman, CFP®, Founder - Progress Wealth Management

Key Terms & Definitions

Keep in mind that these are high-level definitions, and the exact meaning may change depending on what type of compensation they're applied to.

Stock Option – A formal, written offer for a company to sell (and for you to purchase) stock at a specified price, subject to time limits and conditions specified in the option agreement.

Restricted Stock Unit/Award (RSU/RSA) – Equity compensation offered to an employee by way of an agreement in which you'll receive shares of stock (for cash payment, in the case of some RSAs) on a future date. The unit/award should not be confused with "restricted stock."

Bargain Element – Also known as the "spread," this refers to the "discount" for the purchase of stock at a price that is lower than the Fair Market Value (FMV) on the purchase date; essentially, this is the difference between FMV of the stock at the time of grant and its exercise price.

Fair Market Value (FMV) – The price at which the stock is currently trading (private companies may calculate this in slightly different ways compared to companies that are publicly traded).

Grant Date – The date that your units, shares, or options are offered to you by your employer.

Vesting Date – The date (or dates) on which restrictions lapse and the stock becomes available for transfer to you.

Vesting (Vesting Schedule) – The schedule dictating when you may exercise your stock options or when forfeiture restrictions lapse for restricted stock. Vesting is typically a time-based "waiting period" before you can exercise options. Vesting is determined separately for each grant.

Exercise – When you notify the company that you want to purchase the stock and provide payment per the terms of your option agreement.

Exercise Date – The date on which you decide to purchase the security instrument at the option's specified price.

Exercise Price/Strike Price – The preset price at which you are able to exercise your option to purchase shares of company stock (typically FMV on the date of the grant).

Sale Date – The date when you legally dispose of the stock that was acquired, whether it's by sale, gift, or other transfer (as allowed by the plan).

Disqualifying Disposition – The legal term for selling, transferring, or exchanging shares before satisfying the holding period requirements; i.e., two years from date of grant and one year from date of exercise. If you sell, transfer, gift, or short the stock too soon, you lose the tax benefits.

Employee equity compensation is a form of noncash compensation that gives you partial ownership in your company.

		Description	Mechanics
Stock Options	Incentive Stock Options (ISOs)	Give you the ability (or option) to buy company stock at the exercise price, which is hopefully a discount from the stock's current market price. Offered only to company employees.	When you exercise the option, you pay to buy the stock and now own shares. ISOs offer a potential tax benefit if you hold the shares for long enough after exercising.
	Nonstatutory Stock Options (NSOs)	Give you the ability (or option) to buy company stock at the exercise price, which is hopefully a discount from the stock's current market price. Offered to company employees or non-employees such as contractors or vendors.	When you exercise the option, you pay to buy the stock and now own shares. NSOs do not offer the same potential tax benefit as ISOs.
	Stock Appreciation Rights (SARs)	SARs allow you to benefit from an increase in company stock price after the grant date.	SARs function similarly to stock options. When you exercise the SAR, you will receive the appreciation in stock price as either cash or shares.
		PSUs are a promise to provide you with shares once certain performance-based vesting requirements have been met. PSUs do not offer voting rights until vested.	When PSUs vest, you simply own the shares and can hold or sell them if the stock plan allows.
		Restricted stock is a grant of actual shares that usually come with voting rights. They are "restricted" and not technically owned by you until they vest based on certain requirements.	When restricted stock vests, you can hold or sell as the stock plan allows.
Employee Stock Purchase Plans		An ESPP allows you to purchase shares of company stock, usually with some kind of discount.	If you participate in an ESPP, after-tax pay is deduct- ed from your paycheck during the offering period. When the offering period ends, your deferred pay is used to buy company shares.

Stock Options give you the right to buy a specific number of shares of company stock at a preset price, known as the exercise or strike price.

Ideally, the goal is to someday exercise options and buy shares for less (or maybe much less) than the stock's current price. When the exercise price is lower than the stock's current price, the option has **intrinsic value** and is **in-the-money**.

OPTIONS

Leverage is one of the biggest advantages of options. The leverage inherent in options means you can experience gains before actually putting down your own capital.

- If you don't exercise options and the stock's price **increases**, you've seen a benefit without spending money.
- If you don't exercise options and the stock price **decreases**, the option value will decrease, but at least you didn't spend your own money.
- If you exercise your options and the stock price then **decreases**, you've lost both the money you spent on the shares and the money you used to pay any associated taxes.

HOW YOU CAN EXERCISE

1. RECEIVE SHARES:

You pay the exercise price and receive shares in return. If you believe your company's share price is going up, this might be an attractive strategy. However, it's riskier as you end up with equity that may lose value before tax time.

2. CASHLESS: SELL TO COVER

You sell some options to cover the cost of either exercising others or tax withholding (or both). For example, if your options are worth $100,000 and would cost $25,000 to exercise, selling to cover would net you $75,000 in shares, not including any tax withholding. This can help you exercise options if you don't have cash on hand, though it's important to work with a CPA to ensure the right withholding amount.

3. CASHLESS: EXERCISE AND SELL

You sell the options immediately and receive cash. Your employer will usually withhold taxes for you. This is like receiving a cash bonus and choosing not to buy company shares with the proceeds. Make sure to talk to your employer to see what exercise methods are available to you.

EXAMPLE

Say you have 10,000 **Options** @$10 **Exercise Price** $100,000 to buy $15/share **Fair Market Value (FMV)** & sell for $150,000

Total Gross Profit

$50,000

The options are in the money.

Incentive Stock Options (ISOs)

ISOs are only granted to company employees and qualify for potential tax benefits if you hold the shares long enough after exercising.

Depending on your situation, the tax benefit from holding shares long enough can be as high as 17% without considering state or net investment income tax, though for most people, it's not that high.

Employees usually must wait until shares fully vest before exercising their options, although some companies offer early exercise through a special election.

TAX TREATMENT

IF YOU HOLD SHARES FOR

- At least 1 year **after exercise**
- At least 2 years **after grant date**

It is considered **qualified disposition** and may enjoy long-term capital gains tax treatment.

IF YOU SELL SHARES

- 1 year or less **from exercise**
- 2 years or less **from grant date**

It is considered a **disqualified disposition** and gains are taxed as ordinary income.

ALTERNATIVE MINIMUM TAX (AMT)

Exercising ISOs and holding the shares may cause Alternative Minimum Tax (AMT). AMT is a separate taxing system that includes the spread on exercised ISOs and could potentially cause additional taxes. However, when paying AMT, you receive a credit that may allow you to get back some or all of it in future years. If you exercise ISOs but sell the shares before year-end, AMT may no longer apply.

OPPORTUNITY COST

If you wait to exercise, the money you might have used to buy shares can be allocated toward other investments instead. This opportunity cost should factor into your thinking around the right time to exercise your options.

INCENTIVE STOCK OPTIONS STRATEGIES

There's no easy way to decide when and how much to exercise – everyone's situation is different, and much of the ultimate result will depend on factors outside your control. Think strategically about what is within your control to best achieve your own long-term goals. If you are bullish and the company is very young, it can make sense to exercise if the cost to do so and AMT are very low. Once there is a material cost to exercise, it is often not worth the risk (especially if there is little or no liquidity), unless you think the fair value is multiple times the exercise price.

ISOs: **What is your incentive?**

The "incentive" in incentive stock options is the difference between your marginal income and capital gains tax brackets. This is the potential tax benefit ISOs offer. If you want to exercise and hold ISOs to pursue this tax savings, here are some factors and risks to consider.

	ON ONE HAND...	ON THE OTHER HAND...
ACTUAL TAX SAVINGS: Depending on your situation, your incentive tax savings can be as high as 17% without considering state or net investment income tax.	Once you work with your CPA to calculate this incentive, you may feel the potential tax savings are worth the risk of putting down your own money and waiting to sell.	The incentive for many people is not as high as 17%. Once you exercise, the stock may not have to drop very much to wipe out the tax savings you were pursuing. You may feel this potential tax savings is not worth the risk.
LIQUIDITY: Exercising requires spending your cash to buy the shares. Do you have access to the needed funds?	If you don't have the funds, your employer may allow some form of cashless exercise. Otherwise, you'll have to wait. Taking out a loan to exercise options is risky and usually not recommended.	If you do have the funds, can you afford to invest them in a company you're already invested in simply by working there? For non-public shares, if you need the money later, can you sell shares back to your company or through private markets? If not, the money is locked up outside your control – possibly for a long time.
OPPORTUNITY COST: If you do have the needed funds, you could invest them in a diversified portfolio instead of exercising the ISOs. Either or both could go up or down, but a dollar invested in one can't be invested in the other.	**INVEST IN PORTFOLIO** If markets and your company stock both go up, your portfolio and your ISOs will both go up, but you only spent money investing in your portfolio. A portfolio is diversified, ideally.	**EXERCISE ISOs** If markets go up but your company stock goes down, you took a loss on the company shares and missed an opportunity for portfolio growth. Company stock is not diversified.
RISK: How much will the options cost to exercise? Is it a lot or a little? Are you willing to lose a little? Are you able to lose a lot?	If you're at a young startup you really believe in, the total cost to exercise and AMT exposure may be very low. If you feel the upside is high enough and dollars at risk low enough, it could make sense to exercise - keeping in mind, of course, that you could still lose it all.	Exercising and holding can make less sense at a mature company where the cost to buy shares is very high – that's a lot more of your dollars to put at risk. If your company stock goes up, your unexercised ISOs go up, too.
AMT: Due to recent tax law changes, AMT affects far fewer people than before. But AMT is complex - work with your CPA to determine whether it will affect you.	If the ISO spread is very small, AMT may not come into play. But if the spread is very high or you have a very high income, AMT might become a factor.	Even if you do end up paying AMT, your CPA can help you plan how to best utilize the AMT credit. It's possible in future years to get back some, or even all, of the AMT you previously paid.
COMPANY GROWTH: Research your company and its competitors. It's very possible for companies to increase revenues but not overall value.	If you invest in your company's ISOs but the shares never increase, you might have been better off investing in a diversified portfolio instead.	If you feel company revenues and profits will outperform a diversified portfolio significantly, then investing in your ISOs could make sense.

Progress Wealth Management Case Study

Exercise-and-Hold

While many people get excited about options and what their value might mean for their financial future, it's good to remember there are certain strategies
you can either implement or avoid to ensure you are getting the outcome you want. Take Anna, a prime example of the "exercise and hold" predicament.

THE BACKGROUND

Anna is one of the first employees at a successful tech company, XYZ, Inc. **She is granted 100,000 options at $1 a share, which she exercises when the FMV hits $15 per share.**

She is subject to the AMT and ends up owing taxes on $1,400,000

($15 FMV – $1 exercise x 100,000 shares).

Anna knows that XYZ, Inc. is a fast- growing company, and she fully expects her shares to increase in value, so she decides to hold the position for a year.

THE CHALLENGE

Unfortunately, there is a major scandal that occurs at XYZ, Inc., which sends the **stock price plummeting from $15 a share to $3 a share.**

Anna exercised her shares, and after the year end, she is left with stock worth $300,000. Anna is in the process of filing her tax return for the year she exercised and has to include $1,400,000 of income for AMT.

With all of her other income, **Anna owes AMT at 28%, which means she will owe $392,000 in taxes related to her exercise of her shares that are now only worth $300,000.** This doesn't take into consideration any state taxes she may owe in addition to federal AMT.

This story is fictional and does not depict any actual person or event.

THE RESULT

Anna is left unable to pay the taxes even if she were to sell her stock at its current value. This has become a very expensive lesson on how the risk of market volatility can negatively impact those who decide to exercise and hold in the hopes of reducing their tax situation to gain favorable long-term tax treatment.

This is an example of what happened to many people in the early 2000s when the dot-com bubble burst, and thousands of people were left with a very expensive tax liability from their exercise-and-hold strategy that they couldn't afford to pay.

The IRS typically doesn't forgive taxes just because you don't have the money to pay them anymore.

Nonstatutory Stock Options

(NSOs)

Typically used by more mature companies for higher-paid employees as well as contractors, consultants, and other non-employees.

NSOs do not qualify for the same potential tax benefits as Incentive Stock Options (ISOs). When you exercise an NSO, the discount (or spread) between the exercise price and the stock's fair market value (FMV) is generally taxable as ordinary income.

NSOs usually must vest before they can be exercised. Your employer may withhold some taxes at the time of exercise.

Diversifying after exercising

We generally recommend exercising and selling NSOs immediately at vest if you're deep in the money or already have a large position.

NSOs with an underlying stock price only 10%-20% above the strike price have high leverage – there's a lot more potential upside than downside.

Exercising NSOs

While leverage is high

(stock price < 30% above exercise price) might be too early if you think the stock is likely to go up substantially.

While leverage is low

(stock price > 30% above exercise price) can make sense if you want to capture profits and reduce your concentration risk.

Progress Wealth Management Strategy

SOME TAX IMPLICATIONS FOR STOCK OPTIONS

Many people get excited about options and what their value might mean for their financial futures. Certain strategies, which you can either implement or avoid, can help you get the outcome you want.

If you wait to hit certain milestones, you could receive favorable tax treatment if you wait for:

- **Two years from grant date** and
- **One year from date of exercise** to sell your shares.

Once these two milestones are met, any profit you generate from the sale of your stock will be taxed as long-term capital gains. **Note that this holding period is only applicable to ISOs,** and you could be subject to AMT when you exercise the option.

Sometimes, pursuing a tax benefit is risky because you need to keep holding the shares before selling, and the shares could lose value during this time.

Exercising or selling before milestones can mean ordinary income treatment. If you sell or dispose of the stock:

- **Within a year of exercising an ISO** or
- **After more than a year**, but less than two years from grant date

The gains will be subject to ordinary income tax treatment, rather than the often lower-tax long-term capital gain treatment.

However, there may be scenarios in which disposing of the shares before meeting the milestones may be advantageous, especially if you have a heavy concentration.

Keep in mind that these are very high-level guidelines; since every situation is unique, you should check with a professional to see if these apply to you.

Restricted Shares (RSAs & RSUs)

Restricted shares are a company promise to provide you with stock once certain re- strictions lift.

These can be performance or timing restrictions. You can think of restrict- ed shares as a bonus awarded as stock instead of cash. However, like cash, it is taxed as if it was paid as ordinary income.

These types of equity compensation are usually taxed at vesting. In essence, you received a cash bonus and spent all of it on buying company stock. Unless you have a strong reason for keeping the stock, selling immediately at vesting is a good strategy to turn that bonus back into cash and avoid building a large position.

TYPES	DESCRIPTION	TAX TREATMENT
Restricted Stock Awards (RSAs)	RSAs are grants of company stock that are issued to employees as rights to shares of stock that are restricted until the shares vest, which is usually time-based, perfor- mance-based, or a combination. RSAs come with immediate voting rights.	Taxed as ordinary income on the value as of date of vesting. If you're an employee, your em- ployer will withhold federal and state income taxes as well as other payroll taxes for you. Generally, we recommend selling vested RSA shares immediately to diversify and capture profits. This usually doesn't cause extra tax li- ability since you're selling at the same price at which you received the shares.
Restricted Stock Units (RSUs)	RSUs represent an employer's promise to grant company shares to employees based on vesting requirements, performance benchmarks, and/or other restrictions. The key difference is that RSUs are issued in the form of units – not stock – that cor- respond in number and value. Upon vest- ing, you'll get your equivalent shares. The result of this difference is that you are not deemed to be the holder of the shares until vesting and do not have voting rights (un- like with RSAs).	RSUs can be awarded on regular vesting schedules or performance benchmarks, which means that the value of the RSUs on the day of vesting is subject to payroll and ordinary income taxation. Some employers allow stock to be withheld to cover the statutory minimum for taxes when RSUs vest. This means some shares are with- held to cover taxes on vesting, with the remain- ing shares actually distributed to the employee. The ability to sell shares is normally not restrict- ed after vesting, unless the company is subject to "open window" trading policies.

Restrictions

TIME	Sometimes called "service restrictions," this restriction relates to the length of time you are with the company.
PERFORMANCE	This type of restriction bases your access to equity on your achievement of pre-set goals, whether it's company performance (such as revenue growth or margin improvement) or individual performance (such as development milestones).
TRANSFERABILITY	Before your shares vest, you generally cannot transfer your stock compensation, except in very limited situations.

Employee Stock Purchase Plans (ESPP)

An ESPP gives you the opportunity to purchase company shares, typically at a discount.

Selling right at purchase usually realizes ordinary income on any gain, but paying ordinary income tax on a sure gain (i.e. the discount) is still essentially “free” money!

ESPP plans are limited to a maximum of $25,000 worth of contributions, per year, per employee. Shares/units are typically purchased via payroll deductions. Usually, at designated points during the year, your employer then uses the accumulated funds to purchase stock for you.

- If you hold the position longer than 2 years from the beginning of the grant period and over 1 year from purchase, the sale is considered a qualified disposition and may enjoy long-term capital gains tax treatment on a portion of realized gains.
- If a sale occurs before the end of either period, it is considered a disqualified disposition and may lead to realizing a higher level of ordinary income versus capital gains.
- ESPP tax treatment can be complex and depends on price movement during the offering period, the ultimate sale price, and other factors.

TAX TREATMENT

Often, ESPP literature for employees provides an overly simplistic description of the plan’s potential tax treatment of sales. But ESPP tax treatment is far from simple and can require specific tax reporting an employer may not perform correctly for you.

In some instances, you could even end up paying double tax. It is crucial to acquire relevant tax information directly from the plan and utilize the services of a qualified CPA if you choose to participate.

If shares are purchased at a meaningful discount (10% or more), then it’s generally recommended you participate as much as you can afford.

Then, if allowed, sell as soon as you purchase to capture profits and avoid building a heavy concentration.

Progress Wealth Management Case Study

ESPPs & Taxes

Melvin has an ESPP with his company, XYZ, Inc. Here are a couple of different scenarios that impact Melvin tax-wise when he sells, depending on qualifying and disqualifying dispositions.

1

Qualifying Disposition

Melvin holds the position for more than two years, from the beginning of the offering period, including more than one year from the date he purchased.

OFFER PERIOD	JANUARY 1 2019	→	JUNE 30 2019
XYZ, Inc. PRICE	$100		$125

Melvin purchased on July 1, 2019, at a 15% discount to the January 1, 2019, price of $100, which means he had a purchase price of $85 ($100 x [100% – 15%]).

Melvin sold on February 24, 2021, for $130. His $15 discount is taxed as ordinary income and the remaining $30 gain is taxed as long-term capital gains.

2

Disqualifying Disposition

Assume that everything from Scenario 1 is still true, **except Melvin holds the position for less than two years from the beginning of the offering period.** His sale is then considered "disqualified."

Melvin sells XYZ, Inc., on December 15, 2019 – less than two years from the offer period and less than one year from purchase – when it sells for $130.

Melvin then owes ordinary income tax on all gains ($130 – $85 = $40).

Note: The bargain element* of $15 should be included as ordinary income.

*** Bargain Element** – Also known as the "spread," this refers to the "discount" for the purchase of stock at a price that is lower than the Fair Market Value (FMV) on the purchase date; essentially, this is the difference between FMV of the stock at the time of grant and its exercise price.

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Progress Wealth Management's Strategy

A FEW TIPS FOR EXERCISING STOCK OPTIONS

As we've mentioned before, employee equity compensation is complex and unique to your own individual situation. How you exercise will depend on many different variables. However, here are a few additional tips to consider when exercising.

- Consider exercising early with cash if the cost is low and tax hit minimal. It starts the clock early on capital gains. The main risk is that the shares decline. There's also a risk in the form of the opportunity cost of the capital you use, which could have been used elsewhere. If you're leaving your job, then you may be forced to go this route.

- Think about whether you may benefit from a cashless exercise if your shares are liquid or if your company will buy them back. This way, you don't have to raise cash, and you'll be hedging by taking some of your shares off the table if the share price goes down. Sure, you may pay more tax, but you're not putting your existing capital at risk.

- If you're concerned about the volatility of the stock, then don't wait. Exercise and sell right away. You're stuck paying ordinary income tax by exercising and selling at the same time, but this might be a better alternative than stomaching any volatility. If the share price decreases, then you won't see losses on shares you sold.

To learn more, talk to a financial advisor. We offer free initial consultations on your employer equity. Contact us today at progresswealthmanagement.com

Equity Compensation & Your Portfolio

Many people think that equity compensation is automatically equal to a windfall. But the truth is, this is usually not the case for the majority of us. Equity can be a great form of compensation, since it aligns incentives between employees and employers and can enable employees to build long-term wealth. However, while equity compensation may provide you more upside, beware: It can create complications relative to cash compensation. That's why it is so important to understand how much stock is in your portfolio and how that plays into your overall net worth and future financial plans.

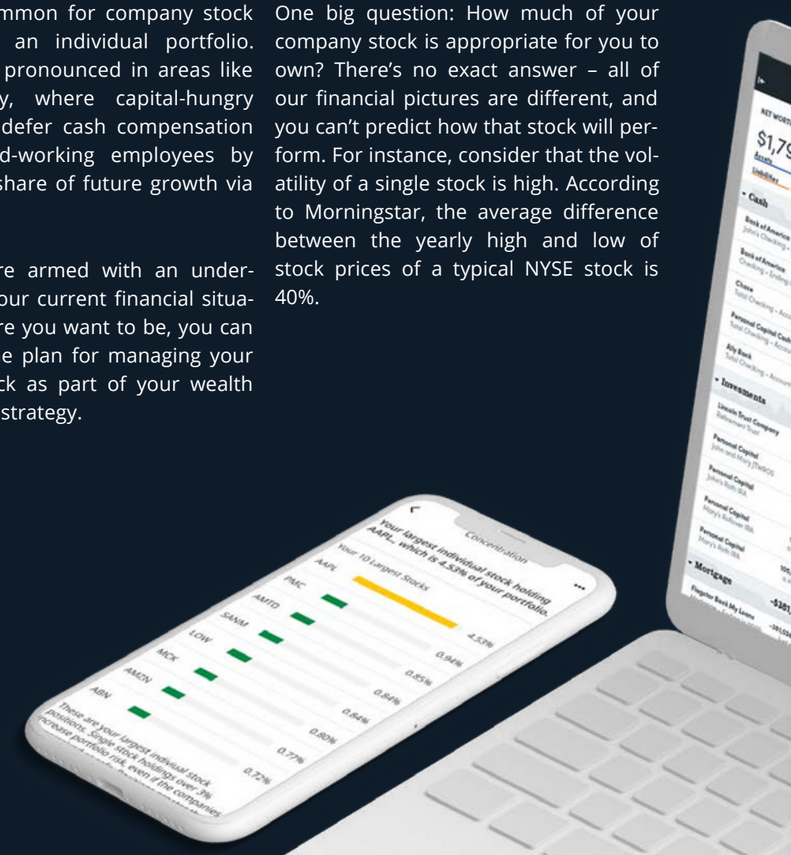
Equity compensation is applicable in both the startup and corporate worlds. But the scenarios are not all equal, and not all recipients find themselves on a path to riches, contrary to popular perception. The extent to which you will benefit from an equity compensation package depends on not only the performance of the stock, but also on how well you manage key decisions relating to your equity. In particular, understanding the type of equity you have and the associated tax implications is critical to your success – as is understanding the risk of investing in an individual stock versus a diversified portfolio.

Managing Exposure

It's not uncommon for company stock to dominate an individual portfolio. This trend is pronounced in areas like Silicon Valley, where capital-hungry compa- nies defer cash compensation to their hard-working employees by promising a share of future growth via equity.

When you are armed with an under- standing of your current financial situa- tion and where you want to be, you can design a game plan for managing your company stock as part of your wealth management strategy.

One big question: How much of your company stock is appropriate for you to own? There's no exact answer – all of our financial pictures are different, and you can't predict how that stock will per- form. For instance, consider that the vol- atility of a single stock is high. According to Morningstar, the average difference between the yearly high and low of stock prices of a typical NYSE stock is 40%.



Progress Wealth Management Strategy

UNDERSTANDING THE VALUE

When you are starting a new job and equity compensation is part of your package, there are some good questions to ask your hiring manager or a member of HR to help you get a handle on what they might be worth. Then you can negotiate other terms based on that knowledge.

SOME GOOD STARTING QUESTIONS INCLUDE:

What type of equity compensation are you offering?	Each kind comes with its own restrictions and tax ramifications, all of which impact what they could ultimately be worth to you.
What is the current valuation of the company?	Sometimes the calculations can be skewed, or companies are not able to give that information. (Although, lack of transparency can also be a red flag.) It's good to at least have a starting point.
How many outstanding shares are there?	This directly ties to the value of any equity you receive. As a simple example, if the share price is currently $10 and there are 100,000 outstanding shares, the company is worth $1,000,000.
What is the risk that future funding rounds cause dilution in the value of my shares?	Depending on the structure of future funding rounds, your equity value could be impacted if new shares are created.
What do the stock documents say?	Reading the fine print takes time, patience, and understanding, but it's crucial to knowing the ultimate worth of what you're being offered. The more information you're armed with, the better you can understand what your equity compensation could ultimately be worth. Speak with a financial advisor to learn more.
Company valuation is very complex.	Even if you learn these important pieces of information, understand that there is always some added risk in working for a company that partially pays you in stock because there's no guarantee it will go up.

Our Take

When it comes to employee equity compensation, you're oftentimes putting yourself into a speculative position.

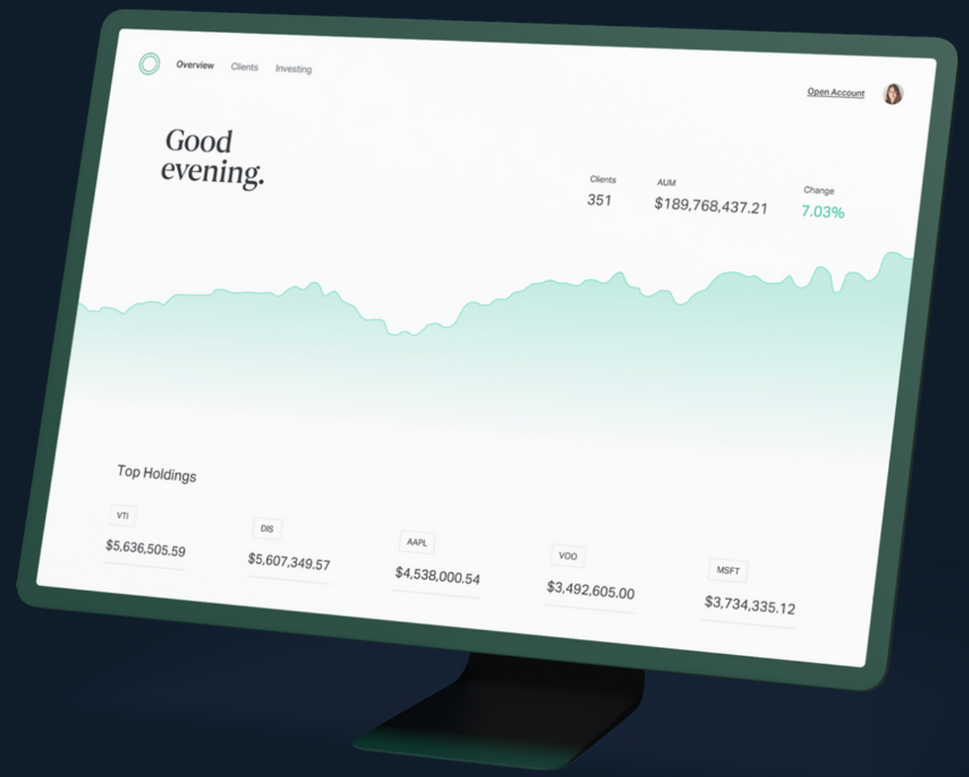
The risk comes if most of your net worth is tied up into it. That's why it's important to understand your awards, the vesting schedule, and the tax consequences so you aren't unnecessarily overpaying, while also managing concentration risk within your overall allocation. Also, you should understand that while taxes are an important aspect to consider, they should not be the underlying reason a diversification strategy isn't implemented.

Rather than letting your employer stock dominate your portfolio, manage your wealth. Figure out how to sell down some of your shares to build a diversified portfolio across the major global asset classes, appropriate for your risk tolerance and long-term goals.

Find out how much your employee equity is really worth.

Get a personalized, complimentary analysis of your financial life.*

Click here to Schedule An Appointment



*Available to individuals who link $100,000 or more in investable assets.

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