The Ultimate Guide to Understanding Equity Compensation

BY

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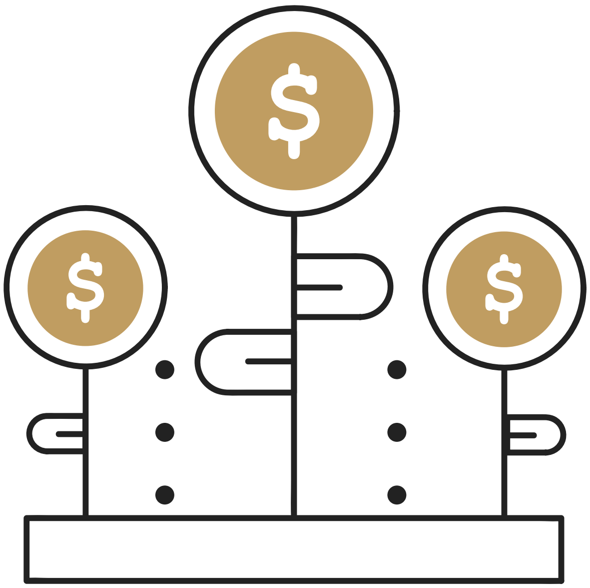
WEALTH

Equity is way to speed up your wealth building and acquire shares in a (hopefully) growing company.

It's also a way to be more aligned with your company - a potential win-win for both employees and employers.



However, as amazing as equity compensation can be, it can also be very difficult to understand.

So this guide walks through common terms to know, different types of equity and how they work, and the tax impact of exercising options.

What Is Equity Compensation?

Equity compensation is when a company pays you in a non-cash form. It's a way to incentivize you to work for them for longer and a way for them to save on paying you as high of a salary if they are a startup and need cash.

With some companies, you receive your equity compensation over a set period of time. With others, you have to buy into it at a discount. Many companies now use this form of compensation as it helps them retain employees and align incentives better.

Terms to Know

- **Grant Date** - This is the date when you are granted/awarded the equity by the company
- **Vested Shares** - These are all the shares that have vested and are yours or can be exercised. This is important to know!
- **Unvested Shares** - These are all the shares that still have yet to become yours, you cannot exercise or do anything until they become vested. If you leave your employer before they are vested, they do not become yours and are worthless.
- **Strike price** - This is the price at which you can exercise your options. You hope it is below the market price so you have a discount.
- **Vesting schedule** - This is how long it takes for the options, RSU's, etc to become yours. If it takes 4 years to vest, then at the 4 year mark you now own them or have the right to exercise them depending on type.
- **Cliff** - The cliff is the date where the first portions of your options vest. Then after the cliff, they typically vest each month, quarter, or year depending on the company.
  - Example: 12/48th's of your shares vest at year 1, then 1/48 per month till the end of year 4. So if you were granted 10,000 shares, 2,500 would vest at the end of year 1. Then 208 per month after that until they all vest at the end of year 4.
- **Cost To Exercise** - This is the total cost to exercise your options and buy those shares. You calculate it by multiplying the number of shares by the strike price that is set for you.
- **Lookback provision (for ESPP)** - A lookback provision bases the purchase price not on the stock price at the time of purchase but, rather, on the price either at the beginning of the offering period or at the end of the purchase period, whichever is lower. Then oftentimes you also have a discount of 5-15% on top of that.

Now, let's get into the different types of equity compensation:

Stock options are a popular form of equity compensation. Options give you the right to buy X number of shares after a certain vesting period. On the vesting date or anytime after is when you can actually choose to buy those shares.

A stock option is the right to buy a set number of shares at a fixed price given to you, called the **strike price**. This price is typically the fair market value of the shares when you got the offer.

They figure this out based on the 409A valuation for the company. The goal is that the share price goes up as you work there, and that you are then given a discount to buy these shares at your strike price, which is hopefully lower than the market price at that time of exercise.

The higher the price has gone up, the more of a discount you will receive.

There are two main types of stock options:

- **Incentive stock options (ISOs)**
- **Nonqualified stock options (NSOs)**

The two are similar, but taxed differently.

With ISO's you do not have a tax when you exercise, unless you exercise enough that triggers the alternative minimum tax (AMT).

We won't get into the weeds of AMT because it varies depending on your financial situation, but know it is something to talk about with your financial planner.

Then, you will have tax once you sell your ISO's. If you sell within 1 year, then you are taxed at short term capital gains rates, but if you hold for a year or longer, then you are taxed at long term capital gains rates.

To recap: with ISO's you do not have tax upon exercise (unless you trigger AMT). Then you will have tax based on when you sell.

NQO's/NSO's on the other hand do have tax when you exercise. Regardless of whether you hold your stock options or sell them, the spread (the difference between the exercise price and strike price) is counted as part of your earned income and taxed at your ordinary income rate. NSOs taxes are withheld at the time of exercise. You need to be aware of this!

To recap: with NSO's you will owe tax at exercise and then again when you sell if you choose to hold onto them after exercise.

Stock options have a certain vesting schedule. Your company might say you will get 10,000 shares at a strike price of $10 with 12/48 vesting at year 1. Then after that, it will be 1/48 a month until all are vested.

This means at the end of year 1, you will have the right to exercise 2,500 shares at a price of $10. Then from months 13-48, you can exercise roughly 208 shares a month.

You are not required to exercise these if you do not want to. However, if you do, make sure you have the cash available to do it. Some companies you have to have cash or use financing. Others allow for cashless exercises where they take away a certain number of shares to cover the cost and you keep the rest.

This typically is only for publicly traded companies though.

Understanding Restricted Stock Units (RSU's)

RSU's are another popular form of equity comp. Eli Lilly, Amazon, Uber, Apple, etc all give out RSU's to incentivize employees to stay. RSU's are granted to you and have a set vesting schedule too, and until they vest they are worthless.

With RSU's, you are given a certain number that will vest at certain dates. You may get 10,000 shares with 25% of them vesting at the 1 year mark, then 25% more at 2, and so on for 4 years until they are all yours. If you leave ahead of time, you will only have the shares that have vested.

You do not need to buy RSU's - they are awarded to you and become yours on the vesting date. The important thing to know is that the taxes are due on the vesting date. They will be taxed as ordinary income on that date. Some companies will take away shares to pay for the tax liability due.

Since taxes are due that day, you then have the option to either keep these shares or sell them and move elsewhere.

You want to think of RSU's like a cash bonus since the tax is already paid. Would you use all those dollars to buy your company stock? If not, you should sell them. If yes, then you will hold onto these shares for the future. Then if you sell within 1 year, you will owe tax at short term capital gains rates, and if you hold for more than a year, you will owe taxes at the more favorable, long term capital gains rate.

You want to be careful with RSU's, oftentimes they end up withholding too little tax (22%) for high income earners. Ensure you do tax planning and projections to make sure you have enough cash on the sideline to pay what is due!

Employee Stock Purchase Plans (ESPP)

ESPP is a stock purchase plan that allows employees to use after-tax dollars to acquire company stock at a discount. Salesforce, Stryker, Goldman, etc all use ESPP plans to allow employees to buy up part of their company.

There are qualified and non-qualified ESPP plans. With a qualified plan, you as an employee are allowed to purchase stock at a discounted price from market value without any taxes owed at the time of purchase. Then once you sell you will either have short term or long term capital gains taxes based on selling your shares at least one year from the purchase date and at least two years from the offering date.

Then with non-qualified ESPP plans, you have the same setup but you do not get the preferred tax treatment. That is really the only key difference.

ESPP plans have a discount of 5-15%, and also can have a lookback provision like we mentioned above.

This is where you get the purchase price not on the stock price at the time of purchase but, rather, on the price either at the beginning of the offering period or at the end of the purchase period, whichever is lower. It’s a pretty great deal to get 5-15% discount plus the lower of the two prices.

As you can see, equity comp can be a great wealth building tool for you as well as a great option for companies to give out.

But, with equity compensation, planning needs to be done to:

- **Ensure you don't become over-concentrated**
- **Know the tax treatment and planning**
- **Ensure you have the cash needed to exercise**

If you'd like to review your equity compensation with a professional, we're here to help you make a plan that works.

Let's talk