FAIRMAN GROUP
FAMILY OFFICE

Financial Planning | Investment Advice | Tax Preparation & Tax Planning

EQUITY COMPENSATION: IN THE NEWS & IN YOUR LIFE

THOUGHT LEADERSHIP PERSPECTIVES

BY ANDREW GREEN, CFP®

You may have noticed quite a few articles in the news recently about Equity Compensation—usually referring to some astronomical amount of compensation that a CEO is being rewarded. While those articles tend to sensationalize executive compensation, "equity" as compensation is quite common—and you may already be the recipient of one or more types of equity compensation.

WE'D LIKE TO INFORM YOU ABOUT HOW TO INCLUDE EQUITY COMPENSATION AS PART OF YOUR TOTAL FINANCIAL PICTURE, AS WELL AS MAKE YOU AWARE OF THE TAX IMPLICATIONS.

Equity compensation is pay in the form of company ownership or stock. It can be awarded instead of, or in conjunction with, regular cash compensation. Many employers consider equity to be a way of aligning an employee's interest with the goals and growth of the company. It could take the form of:

- Restricted Stock
- Stock Options
- Employee Stock Purchase Plans
- Stock Appreciation Rights
- Phantom Stock

We will focus on the the most common types, Restricted Stock and Stock Options.

RESTRICTED STOCK AWARDS

Restricted Stock, referred to as Awards (RSAs) or Units (RSUs), are similar variations on the same general structure. Restricted stock plans are a way to award shares of company stock, where the right to acquire or sell the shares is subject to certain restrictions. The term 'vested' refers to when those restrictions end; and therefore, the employee owns the stock. While every plan has its own unique structure, restrictions are usually time based. For example, an employee's RSUs may grant 100% after having worked with the company for two years. This is known as 'cliff vesting.' Alternatively, the shares may be subject to a vesting schedule, such as 1/3 after the first year, 1/3 after the second year and the remaining 1/3 after three years.

At the time restricted stock is 'granted' or 'awarded' to an employee, there is no tax effect to the recipient. Once the stock is vested, it becomes fully taxable! The recipient owes tax on the vested stock's fair market value on the 'date of vest.' That value is fully taxable just like ordinary salary or wages, and similarly, income and payroll taxes are withheld by the employer.

Here's the potential misunderstanding. Your vested stock's tax withholding rate may be 22%; while your actual tax rate may be much higher. What that means is when it's tax time, you would owe the difference between the two. If you were unaware of this, you're not alone. Furthermore, if you were to sell that stock, the short-term gain vs. long-term gain clock starts ticking at the date of vest. Your tax gain is then determined from the date of vest to the date of sale.

STOCK OPTIONS

An employer may also offer stock options as a form of equity compensation. While incentive stock options (ISOs) have the potential for certain tax benefits, non-qualified stock options (NQOs) are usually more common. A stock option gives the holder the right to purchase stock at a predetermined price, known as the 'strike price,' 'grant price' or 'exercise price.' If all goes well, the strike price will be substantially lower than if the stock was purchased on the open market.

Similar to restricted stock, there is no tax effect upon the granting of NQOs. Tax is not due until the holder exercises the option, at which point the difference, called the 'bargain element' (market value less strike price), is taxable as compensation to the employee, much in the same way restricted stock is.

TOP FACTORS TO CONSIDER:

1. Increased risk associated with overconcentration in a single stock position, especially considering an employee's financial well-being, is likely already tied to the success of the company.
2. Taxation and planning can differ depending on whether the company is public or private.
3. Different compensation structures can vastly change your tax situation, both in amount due and timing of the liability.
4. Strategic planning around sale windows or blackout periods is important to avoid unwanted outcomes.
5. If stock is to be sold, donated or gifted, it is crucial to choose the appropriate grant or vesting lot from which to use.
6. Deciding whether to hold, sell or otherwise dispose of vested stock can depend on many things, such as cash flow, tax situation, performance or expiration.

RESTRICTED STOCK

Advantages

- Unless the stock becomes worthless, restricted stock retains at least some value, even if the stock price drops.
- Recipients may be eligible for dividends or voting rights associated with company stock.
- Recipients may be eligible for certain elections that can provide significant benefits on future taxation:
  - **83(b) Election**: This option allows you to pay taxes on the fair market value at the time of granting, not the time of vesting. This applied to Awards, but not Units.
  - **83(i) Election**: This option allows you to defer paying tax for up to five years (NEW under the tax bill).

Disadvantages

- Recipients must meet certain restrictions or milestones before the stock vests and becomes sellable.
- If not yet vested, the stock is often forfeited upon retirement or termination.

STOCK OPTIONS

Advantages

- Can potentially provide greater value than other equity compensation, given the benefit of inherent leverage and tax deferral.
- Can offer more flexibility, especially from a tax standpoint, because holder controls when the option is exercised.
- Recipients may be eligible for 83(i) Election like restricted stock.

Disadvantages

- Can expire worthless if the stock price is less than the strike price.
- If not exercised, options usually expire ten years from grant.

CONSIDER YOUR LONG-TERM FINANCIAL PICTURE

If you or your spouse receive any type of equity as part of your compensation package, please contact our Advisors to learn more about how this may affect your long-term financial picture and tax situation. We'd like to offer you some suggestions at our first meeting, at no cost to you.

WWW.FAIRMANGROUP.COM | 610-889-7300

Financial Planning | Investment Advice | Tax Preparation & Tax Planning

Investment advisory services are offered through The Fairman Group LLC. The Fairman Group LLC is registered with the Securities and Exchange Commission under Section 203(c) of the Investment Advisers Act of 1940.