Equity Compensation: Taxation and Planning

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Meet Today's Speaker

Wade D. Egmon, CPA, CFP®, Senior Financial Advisor

As Senior Financial Advisor, Wade's responsibilities include working with clients directly, addressing their financial planning needs. He also oversees client relationships and assists other team members with the more complex financial advisory issues. Prior to joining Goodman Financial, Wade served as a financial planner and income tax resource for a family office in Houston offering clients comprehensive financial planning services and targeted analysis. Additionally, Wade has six years of Big Four and small-firm tax experience, specializing in tax compliance and planning for high net worth individuals.

Learning Objectives

- Understand the differences between equity compensation plans available
- Learn key terms associated with equity compensation plans
- Understand the taxation of the various types of plans
- Discuss tax planning opportunities and principles associated with employer stock

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What is Equity Compensation and Who is Eligible?

What is equity compensation?

- Non-cash compensation in the form of company ownership offered to employees
- The company may give the employee the option to buy shares or grant the employees shares
- Allows employees to participate in the growth of the company and encourages retention

Who is eligible?

- Individuals who work for a company that has an equity compensation plan in place
- Often awarded to key employees and executives
- Startups or companies with limited cash flow may offer to employees to supplement cash compensation

Types of Equity Compensation

Grants

- Stock Grants
- Restricted Stock (RSUs or RSAs)
- Stock Appreciation Rights (SARs)

Options

- Non-Qualified Stock Options (NSQOs)
- Incentive Stock Options (ISOs)

Employee Stock Purchase Plans (ESPPs)

Tax Rates

2023 Tax Brackets - Married Filing Joint Taxpayers				
If Over	But Not Over	Pay	+	Of Excess Over
$0	$22,000	$0	10%	$0
$22,000	$89,450	$2,200	12%	$22,000
$89,450	$190,750	$10,294	22%	$89,450
$190,750	$364,200	$32,580	24%	$190,750
$364,200	$462,500	$74,208	32%	$364,200
$462,500	$693,750	$105,664	35%	$462,500
$693,750		$186,602	37%	$693,750

2023 Effective Tax Rate - MFJ		
Taxable Income	Pay	Effective Tax Rate
$22,000	$2,200	10.0%
$89,450	$10,294	11.5%
$190,750	$32,580	17.1%
$364,200	$74,208	20.4%
$462,500	$105,664	22.8%
$693,750	$186,602	26.9%

Taxable Income	Tax Brackets
Married Filing Joint	**L/T Capital Gains/Qualified Dividends Rate**
Up to $89,250	0%
$89,251 - $553,850	15%
$553,851 or more	20%

FICA Tax	
Tax	**Employee Pays**
Social Security	6.2% for the first $160,200 earned
Medicare	1.45%
Additional Medicare Tax	0.9% on earnings over $250,000

NOTE: 2023 tax brackets. 3.8% net investment income tax applies to taxpayers with AGI above $250,000 (married filing joint). LT capital gain/qualified dividend rates above are applied to the incremental LTCG and QDs in those taxable income ranges.

Stock Grants

Key Terms: Stock Grants

Grant date: Date on which the stock is issued

Vesting: Earning the rights to employer stock over time - "If I leave the company, will I retain the full value of my stock?"

- Immediate vesting
- Graded vesting – Employee receives a certain percentage of vesting after each year of service
- Cliff vesting – Vesting occurs entirely on a specific date

Fair market value (FMV): Price that a share is currently trading for (publicly traded) or valued at (privately held)

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Stock Grants: Vested Stock

- Immediate vesting
- Taxed at fair market value as ordinary income (compensation) and subject to FICA taxes – reported on Form W-2 when received
- If you are an employee, your company will withhold taxes for the grant
  - Includes federal and FICA taxes
- Basis is usually the fair market value of the shares at the grant date (excludes any withholding)

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Stock Grants: Restricted Stock

- Specifically designed to retain employees - graded or cliff vesting schedule
- Taxation occurs upon the vesting date
  - The FMV is taxed as ordinary income (compensation) and subject to FICA taxes – reported on Form W-2
- If you are an employee, your company will withhold taxes for the grant at vesting (Federal and FICA)
- Basis is usually the FMV of the shares at the vesting date (excludes any withholding)
- Long-term capital gain holding period starts when the stock vests (exception for 83(b) election)
- There are two main types of Restricted Stock:
  - Restricted Stock Award (RSA) – Receive grant of actual stock that vests in increments (held in escrow)
  - Restricted Stock Units (RSUs) – An unfunded promise to give a number of shares in the future according to vesting schedule

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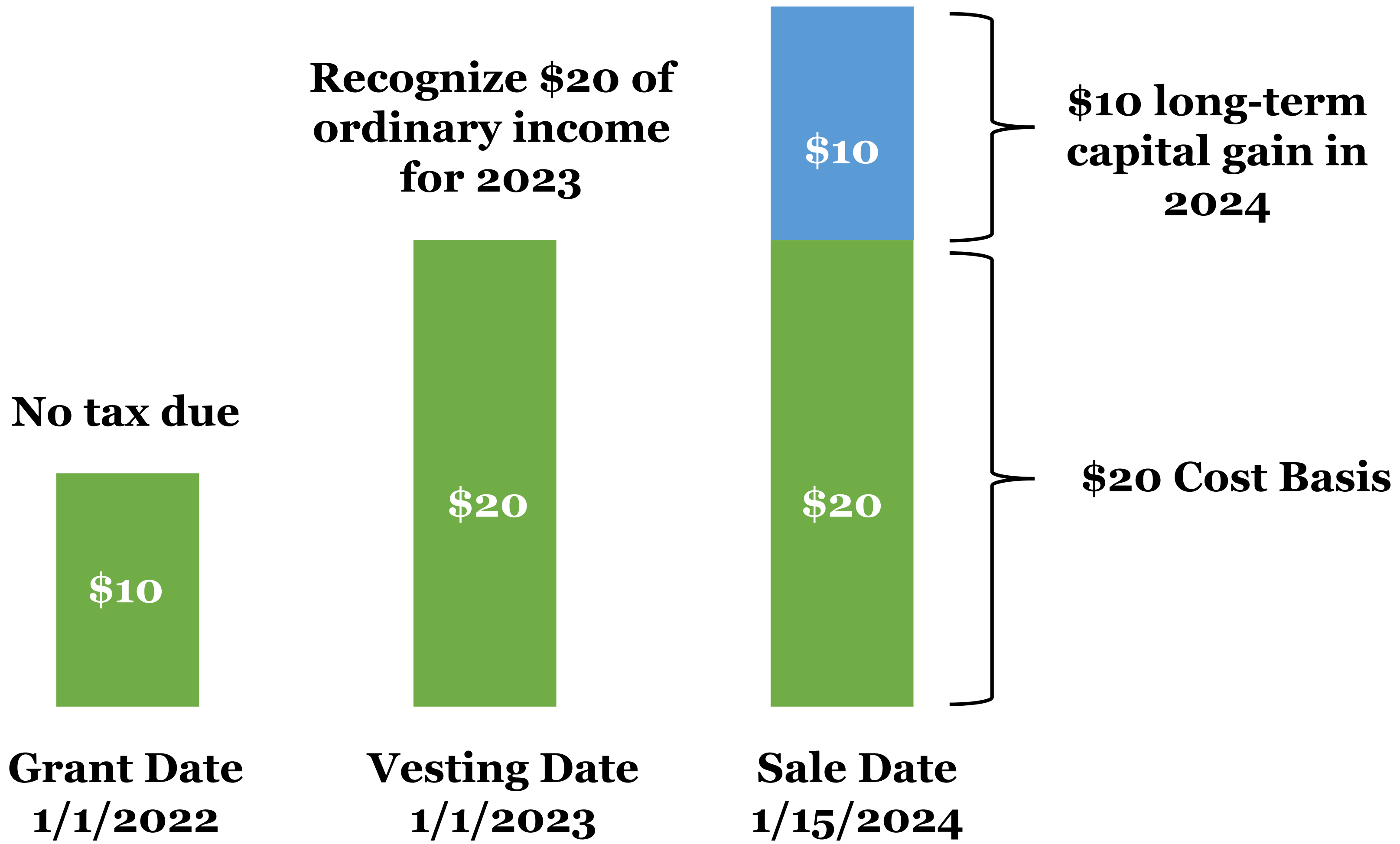
Restricted Stock Example

On January 1, 2022, Mark receives an RSU grant from Company ABC for 1,000 shares. January 1st, the value is $10 per share. These shares have a 3-year graded vesting schedule.

Vest Date	Shares Vested	FMV at Vesting Date	Compensation Income
1/1/2023	333	$20	$6,660
1/1/2024	333	$30	$9,990
1/1/2025	334	$40	$13,360
Total:	**1,000**		**$30,010**

On January 15, 2024, Mark sells his first tranche of vested stock for $30. Since he has held the vested shares for at least 12 months, he receives long-term capital gain treatment on the $10 gain of the stock.

Restricted Stock Units (RSUs) Example



Restricted Stock Awards vs. RSUs

Restricted Stock Awards		Restricted Stock Units
Shares issued at grant and held in escrow until vested	**Logistics**	Shares are not issued until payout date
83(b) election can be filed at grant	**Early Exercise**	Not Eligible
Non-transferrable	**Transferability**	Non-transferrable
Usually have voting rights, even before vesting	**Voting Rights**	No voting rights until payout
Usually receive dividends on unvested shares	**Dividends** (taxed at ordinary income rates until vested)	Do not receive dividends, but may earn dividend equivalents
Ordinary	**Taxable Income**	Ordinary
No limit after vesting	**Term**	No limit after shares are received at vesting

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83(b) Election

- Applies to Restricted Stock Awards
- After filing, ordinary income and FICA taxes are paid based on the value on the grant date rather than the vesting date
- Holding period begins on the grant date
- Election must be made within 30 days of receiving the stock
  - Sample election: https://www.irs.gov/pub/irs-drop/rp-12-29.pdf
- Good idea to make the election under certain scenarios:
  - High growth potential of stock – taxes paid now would be less than if paid at vesting date
  - Taxpayer is in a lower tax bracket at grant than expected at vesting
  - Low likelihood of forfeiture - if you forfeit the stock before it vests, you still must pay taxes

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83(b) Election Example

On January 1, 2022, Mark receives an RSA grant from Company ABC for 1,000 shares. These shares have a 3-year graded vesting schedule. Currently, Company ABC stock is worth $10/share.

Vest Date	Shares Vested	FMV at Vesting Date	Value at Vesting Date
1/1/2023	333	$20	$6,660
1/1/2024	333	$30	$9,990
1/1/2025	334	$40	$13,360
Total:	**1,000**		**$30,010**

If the 83(b) election occurs on 1/2/2022:

- Compensation Income = $10,000 (1,000 x $10), future gains on sale of vested stock after 1/3/23 is taxed at long-term capital gains rates
- Federal and FICA taxes occur in 2022 when the grant occurs, as opposed to when the shares vest

Stock Options

Stock Options Overview

- Option to buy company stock at a specified price on a future date
- Grants are made according to the specific company's agreed upon plan
  - Vesting Schedule:
    - When does vesting start?
    - Graded or cliff vesting schedule?
  - Exercising Options:
    - How?
    - When does it expire?
    - What happens if I leave or die?

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Key Terms: Stock Options

Grant date: Date on which the option is issued

Vesting: Earning the right to buy employer stock over time - "If I leave the company, will I retain the full value of my option?"

- Immediate vesting
- Graded vesting – Employee receives a certain percentage of vesting after each year of service
- Cliff vesting – Vesting occurs entirely on a specific date

Strike/Exercise/option price: The price at which the stock can be purchased

Fair market value: Price that a share is currently trading for (publicly traded) or valued at (privately held)

Bargain element/spread: Fair market value minus the exercise price on the date of exercise

"Under water": FMV < exercise price

Expiration/Expiration date: Date on which you can no longer exercise your option to purchase stock

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Non-Qualified Stock Options (NQSO) Overview

- Taxation occurs upon exercise, i.e. purchase of the stock
- The difference between the fair market value and the exercise price (bargain element) will be taxed as ordinary income (compensation) and subject to FICA taxes – reported on Form W-2
- The cost basis in the stock is the amount paid for the stock plus the amount of income reported upon exercise
- Holding period begins on the date of exercise
- After exercise, any gain/loss on stock is taxed at capital gains rates
- Sales are reported on Form 1099-B
- Note, some employers allow for employees to make an 83(b) election to exercise unvested NQSOs, election is made within 30 days of exercise

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NQSO Exercise Methods

Cash

- Purchase the shares at the option price with ready cash or with cash obtained by liquidating assets or borrowing

Cashless Exercise/Same-Day Sale

- Works if you don’t have cash on hand or don’t want to hold all the shares
- Can sell all shares or only enough to cover the exercise
- Portion of the sale proceeds goes to pay the exercise price and withholding taxes
- Any market movement can be taxed as a capital gain

Using Stock

- Currently owned company shares (valued at market price) are swapped to exercise as many stock options as possible (valued at the option price)

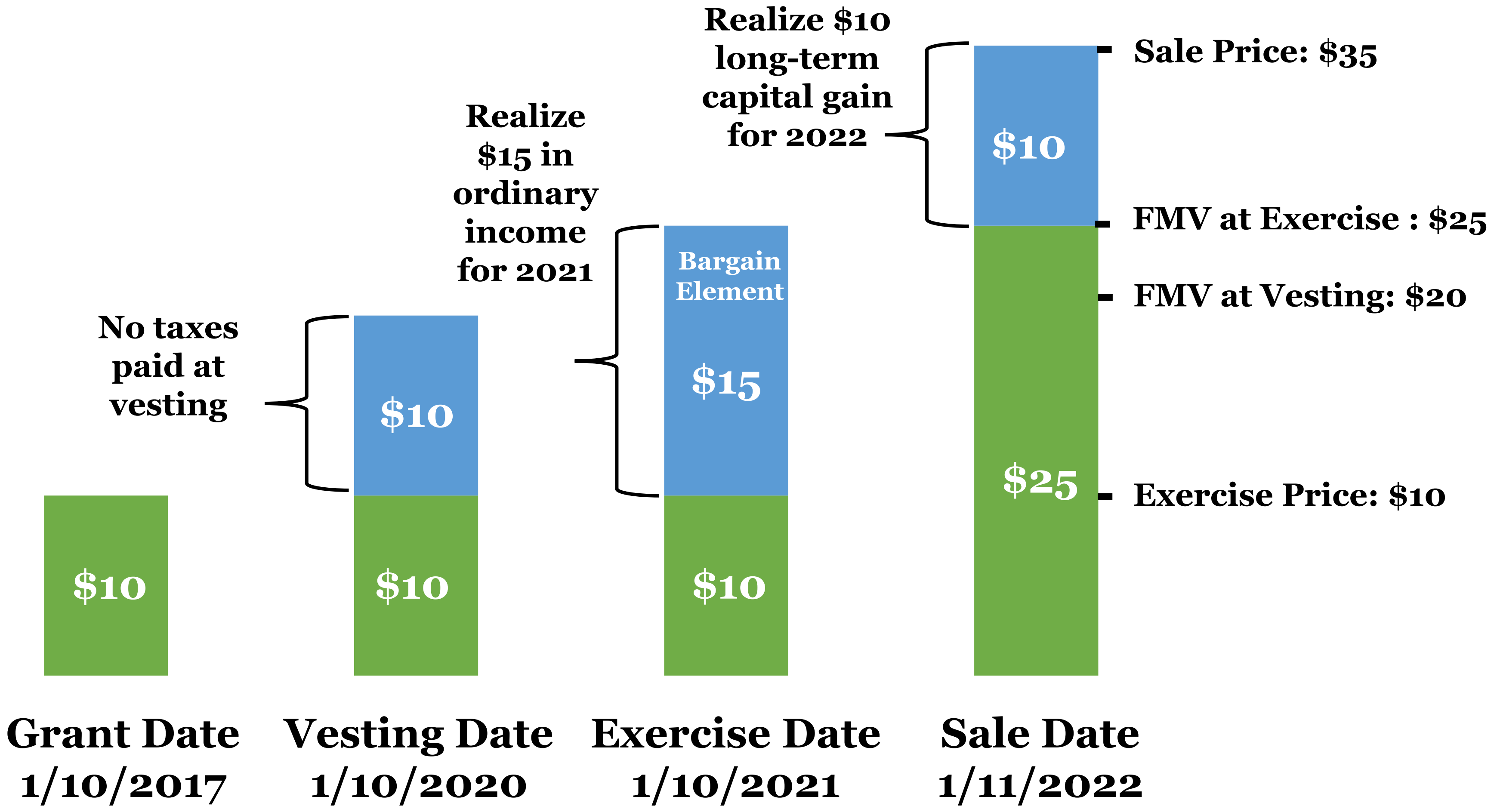
NQSO Example

On January 10, 2017, Suzie is awarded a grant of 1,000 nonqualified stock options with an exercise price of $10. These options will cliff vest in 3 years. On January 10, 2020, all 1,000 options vest when stock is trading at $20 per share.

On January 10, 2021, the stock is trading at $25 per share and Suzie decides to exercise all 1,000 options on that date.

On January 11, 2022, Suzie decides to sell all 1,000 shares of stock when the stock is trading at $35 per share.

Non-Qualified Stock Options (NSQOs)



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Incentive Stock Options (ISO)

- ISOs get preferential capital gains treatment if they are **held for more than 2 years beyond the date of grant <u>AND</u> 1 year beyond the date of exercise** (Qualifying Disposition)
- Qualifying Disposition - Upon exercise, the difference between the fair market value and the exercise price (bargain element) is NOT subject to ordinary income or employment taxes
  - However, the bargain element is a preference item for Alternative Minimum Tax (AMT) purposes, which may cause employee to be subject to AMT
  - After exercise, there is separate cost basis for regular tax purposes (exercise price) and AMT purposes (exercise price + AMT preference recognized), any gain/loss on stock is taxed at capital gains rates
  - Holding period begins on the date of exercise
  - After exercise, Sales are reported on Form 1099-B

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Incentive Stock Options (ISO)

- Additional Notes
  - Cash or cashless exercise available
  - Note, some employers allow for employees to make an 83(b) election to exercise unvested ISOs, election is made within 30 days of exercise (holding periods must be met for ISO treatment)
  - $100,000 Rule - To the extent the aggregate fair market value of stock to which ISOs are exercisable for the first time in a calendar year exceeds $100,000, such options shall be treated as NQSOs

Alternative Minimum Tax: A Brief Overview

- AMT is designed to prevent taxpayers from escaping their fair share of tax liability through tax breaks
- The AMT recalculates tax after adding certain tax preference items and disallowed deductions back to taxable income.
- Alternative minimum taxable income is taxed at 26% or 28%
- Resulting calculation = tentative minimum tax
- AMT = Tentative minimum tax minus standard tax
- If you pay AMT in one year due to ISO exercises, there will be a minimum tax credit carryforward to offset future years regular tax liability to the extent it exceeds tentative minimum tax

- AMT less applicable due to changes from the TCJA
  - Higher AMT Exemption amount and phaseout levels
  - State income and property tax cap of $10,000
  - Elimination of personal exemption and miscellaneous itemized deductions

ISO Qualifying Disposition Example

On January 10, 2019, Suzie is awarded a grant of 1,000 incentive stock options with an exercise price of $10. These options will cliff vest in 1 year. On January 10, 2020, all 1,000 options vest when stock is trading at $20 per share.

On January 10, 2021, the stock is trading at $25 per share and Suzie decides to exercise all 1,000 options on that date.

On January 11, 2022, Suzie decides to sell all 1,000 shares of stock when the stock is trading at $35 per share.

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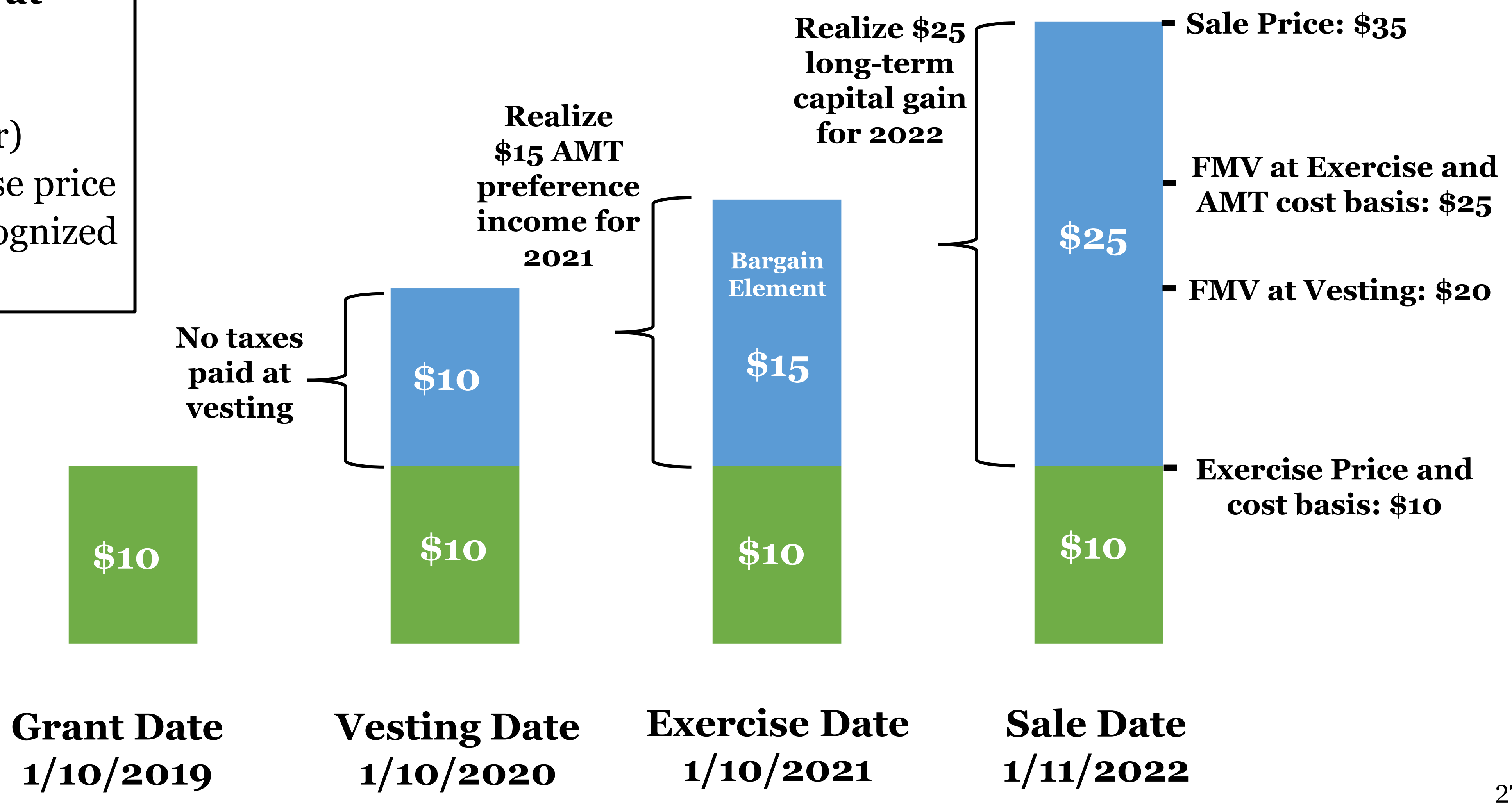
Incentive Stock Options (ISOs) Qualifying Disposition

Cost Basis set at Exercise

- Regular tax purposes: exercise price ($10/shr)
- AMT purposes: exercise price + AMT preference recognized ($25/shr)



ISO Disqualifying Disposition Example

On January 10, 2019, Suzie is awarded a grant of 1,000 incentive stock options with an exercise price of $10. These options will cliff vest in 1 year. On January 10, 2020, all 1,000 options vest when stock is trading at $20 per share.

On January 10, 2021, the stock is trading at $25 per share and Suzie decides to exercise all 1,000 shares on that date.

On **March 1, 2021**, Suzie decides to sell all 1,000 shares of stock when the stock is trading at $35 per share. **Since the shares were not held for at least a year beyond the exercise date, this represents a disqualifying disposition.**

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Incentive Stock Options (ISOs) Disqualifying Disposition

Scenario 1
Sale price is higher that the value of shares on date of option exercise

1. Bargain element = compensation income
2. Gain above basis = capital gain (LT or ST)

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Incentive Stock Options (ISOs) Disqualifying Disposition

Scenario 2

Sale price is above amount paid for the shares but not higher than the value of the shares as of exercise date

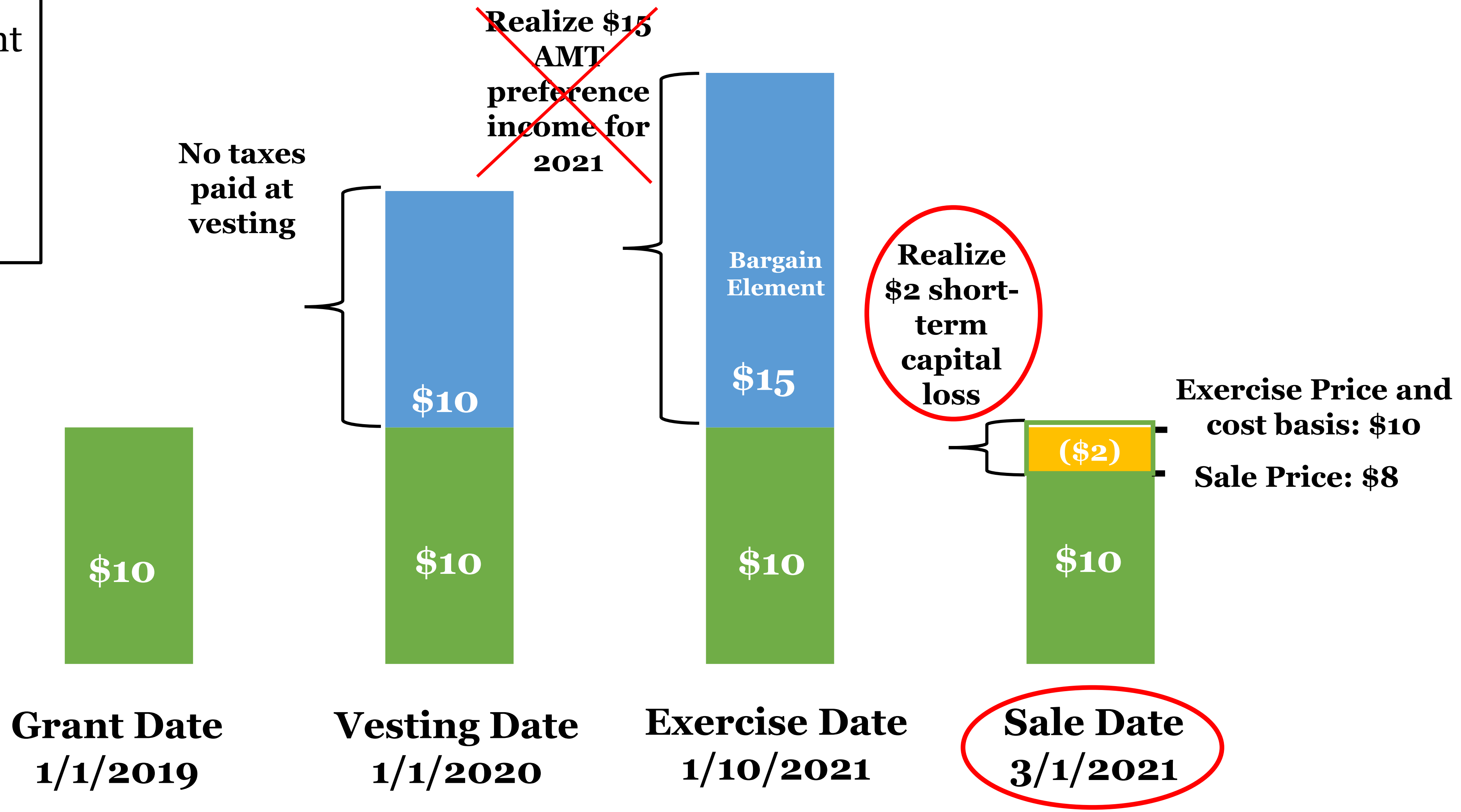
Treated as compensation income

Incentive Stock Options (ISOs)
Disqualifying Disposition

Scenario 3

Sale price is below amount paid for the shares

Treated as a capital loss (recorded on Schedule D



NQSO vs ISOs

Non-Qualified Stock Options		Incentive Stock Options
Employees, Directors, Consultants	**Who Receives the Grant**	Employees Only
Transferable	**Transferability**	Non-transferrable, except on death
None	**Grant Limit**	$100,000 rule
Exercise	**Triggering Event**	Sale of stock
Ordinary	**Taxable Income**	Long-term capital gain potential
None	**Impact on AMT**	Preference item at exercise

Stock Appreciation Rights

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Stock Appreciation Rights

- Rights that grant to the holder cash in an amount equal to the difference between the fair market value and exercise price
- Payments received for SARs are ordinary income (compensation) and subject to FICA taxes – reported on Form W-2
- Rights cannot be exercised earlier than one year and later than 5 years
- Usually granted with NQSOs and ISOs to provide cash to exercise the options
- Generally subject to requirements of tax code 409A

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Stock Appreciation Rights Example

Bob is a key executive in ABC company. He is granted 1,000 SARs. The trading price of ABC company at the date of grant is $20. If Bob exercises the SARs in two years when ABC company is valued at $60, how much will he receive?

# of shares	Exercise Price	Current Price	Dollars Received	Taxable Amount
1,000	$20	$60	$40,000	$40,000 (W-2 Income)

Employee Stock Purchase Plans

Employee Stock Purchase Plans

- Plans will vary at each company but have similar components
- Allows employees to buy employer stock for a discounted price through ongoing payroll deductions, intended to benefit all or a large portion of employees
- Offering Period – Period where pay is withheld to eventually purchase stock
- Stock is purchased with after-tax dollars at the end of the offering period, lookback period can apply to purchase price
    - Example: purchase price = 85% of lesser of FMV at the beginning or ending of offering period
- Discount on company stock can vary up to a maximum of 15%
- Ability to purchase is capped at $25,000 per year (FMV as of date of grant)
- Taxation only occurs upon sale of the ESPP shares

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ESPP Stock Sale Taxation

	Qualifying Disposition	Disqualifying Disposition
Terms	Stock held at least one year from purchase date and two years from offering/grant date	Anything that isn't qualifying
Compensation Element	Lesser of: • FMV of stock on grant date minus actual amount paid • FMV of stock when sold/gifted minus actual amount paid	Bargain element (FMV on purchase date minus amount paid for stock)
Tax on Compensation	Ordinary Income, Form W-2	Ordinary Income, Form W-2
Tax on Growth	LTCG; Basis = amount paid + compensation element; Sale reported on Form 1099-B	ST or LT capital gains; Basis = amount paid + compensation element; Sale reported on Form 1099-B
Additional Information	If shareholder dies, death treated as a qualifying disposition even if holding period is not met	If stock decreases in value, could report ordinary income on discount and capital loss in the same year

Equity Compensation Planning Principles

- Read stock plan agreements well
  - Know vesting schedules, when options expire, what happens at retirement, termination, change of control, etc.
- Be aware of blackout periods
- Can equity compensation be negotiated before employment?
- Plan ahead to the extent you can
  - 83(b) election
  - Tax planning around known income (Example: timing of exercises/sales vs. RSU/RSA vesting periods)
- Create a plan for reducing a concentrated equity position
  - Selling
  - Gifting appreciated shares to charity/DAF

Conclusion

- Equity compensation plans can be lucrative
- Know any equity compensation plans you are eligible for and understand the tax implications of each
- Tax implications can sometimes be out of your control
- Planning for tax implications of equity compensations can provide significant value

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Thank you

Additional information or answers to questions can be obtained by contacting:

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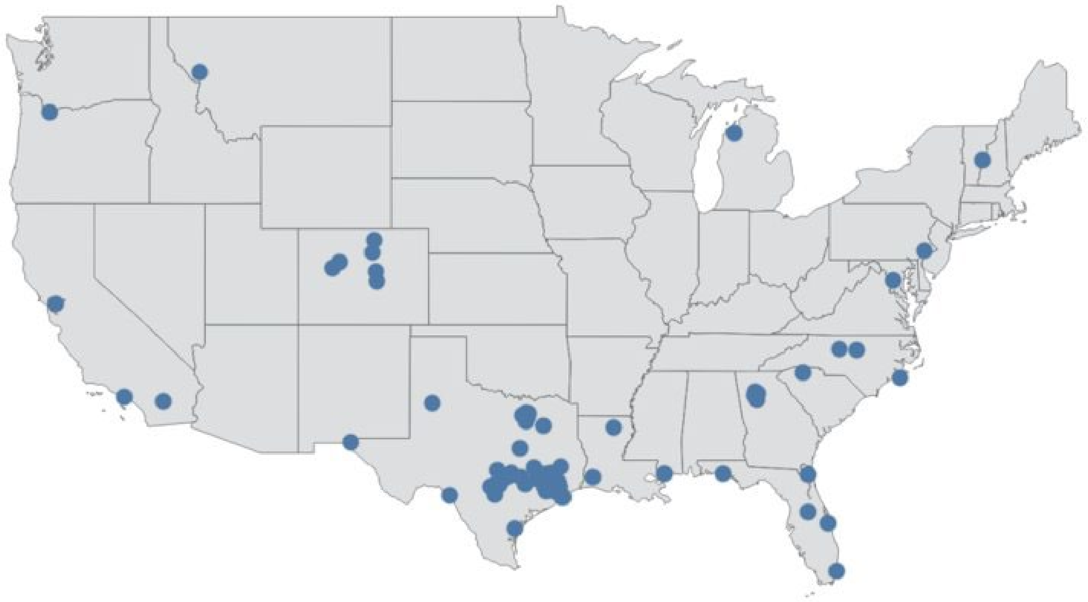

As of December 31, 2022

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