



Managing Your Equity Compensation In Volatile Markets

By Kristi Mathisen



KRISTI MATHISEN,
JD, CPA, PFS

Kristi is LNWM's managing director of tax and financial planning. An attorney and CPA, she has more than 20 years of experience providing analysis and guidance on tax and wealth planning issues.

As stock prices have risen in the past decade, restricted stock and other types of equity compensation have become a major asset for many people, especially those in the tech sector.

What we have observed are two tendencies: either to overestimate the value of equity comp in making financial decisions; or to underestimate it (and leave it on autopilot). There are risks to both tendencies. For people with significant equity compensation accumulated over many years, an autopilot approach can mean missed opportunities. Likewise, newer employees who base major financial decisions on the value of restricted stock can end up in a bind.

Here at LNWM, we help clients to actively manage their equity compensation in a way that reduces risk and supports their financial and life goals. This is especially important now that equity valuations are near record highs and markets are becoming more volatile. The following are four key things we help clients consider as we develop equity comp strategies.

The Basics: The Three Most Popular Types of Equity Comp

Restricted Stock Units (RSUs)

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.

Example: Amazon caps salaries at \$160,000 a year but supplements with RSUs that can be worth much more than that, based on a four-year vesting schedule of 5% / 15% / 40% / 40%.

Restricted Stock Awards (RSAs)

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. Usually, RSAs are awarded by startups.

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. Netflix, for example, offers employees the chance to buy stock options using part of their salary, in addition to granting them a certain number of options as compensation.



#1. What Do You Own When?

Due to changes in accounting rules and some well-publicized unfortunate tax outcomes, stock options have lost favor in recent years and the granting of restricted interests (RSAs, RSUs) is now much more common. There are big differences between options and restricted stock.

With stock options, you do not own stock until you exercise the option to purchase. If the market price of the stock drops below the option's guaranteed purchase price (the "strike" price), the option can expire worthless.

With RSAs and RSUs, you are issued shares of stock, either right away (RSAs) or in the future (RSUs) at little or no current cost to you. You cannot sell the shares until they vest. However, unless the issuer goes bankrupt, RSAs and RSUs will be worth something when they vest. They may be worth less than when you were issued them, but chances are they will be worth something.

In recognition of this, some Seattle lenders will consider Amazon employees' un-vested RSUs as earnings when qualifying for mortgages. Is this a good idea? Perhaps not, when the average tech worker tends to change jobs in less than three years and even CEOs are changing jobs more frequently these days.

RSU Taxes: A Timeline

1	2	3	4	5
Grant	Vesting	Vesting Year Income Taxes*	Sale of Stock	Sale Year Amount
Grant Date: January 5, 2018	Vesting Date: January 5, 2020	2020 Compensation Income: $\$20,000 = \200×100	Sell Date: January 6, 2021	2021 Realized Long-Term Gain: $\$4,000 = \$25,000 - \$21,000$
RSUs Granted: 100 RSUs that can be settled for 100 shares on the vesting date, Jan. 5, 2020.	Market Price: \$210	FICA/Medicare tax: \$1,530	Market Price: \$250	
Settlement Price: \$10/share	Compensation Income: $\$200/\text{share} = \$210 - \$10$	Federal Income Tax: \$4,400 <small>*Assuming federal income tax bracket of 22%.</small>	Gross Proceeds: $\$25,000 = (\$25 \times 100)$	Note: If the stock is sold less than a year after vesting, any profit would be taxed as a short-term capital gain (at the same rates as regular income).
			Cost Basis: $\$21,000 = (\$200 + \$10) \times 100$	

#2. What Taxes Are Due When?

Taxes on equity comp vary and often catch people by surprise. Restricted stock is especially tricky because there are two separate income events involved, even though many employees do not realize this.

EVENT 1: You owe ordinary income tax at vesting, the date that your RSU or RSA grants convert into stock that you can sell (or into cash for certain RSUs).

The income tax is levied on the market value of the shares when they vest (minus anything you may have paid for the shares). Your employer deducts this amount as an operating expense (employee



compensation), and you pay the income tax on it – at ordinary income tax rates (12% to 37%) plus Social Security and Medicare. You can choose to automatically sell some of your vested shares to pay taxes due at vesting.

It's important to realize that on your vested shares, you have paid taxes on a value that may drop by the time you sell.

EVENT 2: You owe capital gains taxes if you sell the stock for a profit.

How much you will owe in capital gains tax depends on how long you held the stock after vesting. If you sell within 12 months of vesting, any gain between the market price at vesting and the sales price is taxed as a short-term gain (at your highest marginal income tax rate, which currently is 37% for the highest earners). But if you sell after a year, any gain is taxed at the more favorable long-term rate, which is now 20% max.

Note: Both short- and long-term gains could also be subject to an additional 3.8% net investment income tax that applies when total income exceeds \$200,000 a year (\$250,000 if you file a joint tax return).

Should you wait to sell to get the lower capital gains rate? Not necessarily. You have already paid a bunch of income tax at vesting. And unless you expect the shares to appreciate significantly in the coming year, it might make sense to diversify and cash-out some of your shares as they vest, at little or no capital gains tax.

Note that RSAs give you a bit more wiggle room as to when to pay taxes, through what is known as an 83(b) election. You can opt to pay income taxes on the value of the shares at the date they are granted to you (when your gain is likely to be lower), instead of the vesting date. This secures capital gain treatment for all future appreciation in the shares but comes with a cost — paying taxes on stock you cannot yet sell — and the risk that you will have overpaid taxes if the stock price drops before you sell.

#3. What Happens When You Leave the Company?

Typically, cessation of employment for any reason – you get sick, quit, get fired – means you forfeit your unvested shares. In case of death, at some companies your unvested shares are forfeited, while at others the shares automatically vest and your heirs can then own them. So it's very important to know your employer's specific policy. You can then decide if it makes sense to purchase life and/or disability insurance to cover the value of unvested stock.

What if your company is acquired or merges with another company? The vesting schedule might be accelerated. It's important to find out how the deal will affect your stock options or grants before taking any action.

AVOID EXTRA TAXES: SYNC YOUR W-2 TO YOUR 1099

At tax filing time, pay careful attention any Form 1099s you receive on the sale of employer stock. The investment firm you sold the stock through may not have records of your cost basis, which is the amount you paid taxes on at the vesting or grant date. You will have to provide that information on your tax return; otherwise, the IRS will treat your cost basis as zero, resulting in a higher taxable gain.



Be sure to review the beneficiaries named on your equity comp forms. Since stock grants range from three to 10 years, many things can change in your life during that time (marriage, divorce, children, etc.), and this should be reflected in the beneficiary designations you have made.

#4. What's Your Plan For Selling and Transferring?

Having too much stock in the company you work for, even if you know the outlook to be great, is a risk. The way to lower that risk is to have a tax-aware plan in place so that you can systematically review your upcoming exercise dates for options or RSUs and periodically sell a certain portion of vested shares and reinvest the proceeds to diversify your investments.

What you sell - and when - depends on your needs and goals for the next 10 to 20 years. To what extent are you relying on equity compensation to meet those needs? The company you work for might well continue to grow. But its stock price could falter. What impact will a drop in your employer's stock price have on your vested and unvested shares?

For those with vested stock that has appreciated greatly, taxes are a key consideration. There are strategies you can use to manage and possibly lower your tax bill while furthering your goals. For instance, you can transfer restricted shares to family members, a non-profit organization, or to a trust.

Active Management Is Key

Equity comp is a means, not an end, and it must be thoughtfully managed to attain your goals. You can use stock awards to qualify for a larger mortgage, make gifts of stock, sell and diversify your investments, fund a trust for future generations and/or charities — or all of the above. The important thing is to align your equity comp with your overall financial plan, instead of letting it drive major financial decisions or go on autopilot. We are here to help you do just that.

Taxes on Stock Options: What's Your Type?

There are two types of stock options, and each is taxed differently:

Incentive Stock Options (ISOs)

— granted only to employees.

Taxes: When you exercise ISOs to purchase stock, any difference between the market price and the option's "strike" price is taxable only for those subject to the Alternative Minimum Tax (AMT), which under current law affects very few people. If you hold the stock for more than one year – and for at least two years after the options were granted – and then sell, the profit (if any) will be taxed as a long-term capital gain.

Non-Qualified Stock Options (NQSOs)

(NQSOs) — granted to contractors, suppliers, investors, as well as employees.

Taxes: Upon exercise of NQSOs, you will owe income taxes on the difference between the market and strike price. That income is also subject to payroll taxes if you received the options for employment. If you hold the stock for more than one year and then sell, you recognize a taxable long-term capital gain (or loss).



Asset Rich, Cash Poor: How to Get Liquid Without Drowning in a Sea of Taxes

Do you own real estate or other assets that have skyrocketed in value? 4 tax-efficient strategies for cashing out.

[Learn more](#)



ABOUT THE AUTHOR

Kristi Mathisen, JD, CPA, PFS is Managing Director of Tax and Financial Planning at Laird Norton Wealth Management. In addition, she provides guidance and advice on philanthropic strategies and estate planning to the firm's client services team and to clients directly. An attorney, CPA and Personal Financial Specialist with more than 20 years of finance-related experience, Kristi has a bachelor's degree in business administration from the University of Washington and a Juris Doctor from the University of Washington School of Law. She is a member of the Washington State and King County Bar Associations, the Washington State Society of CPAs and the American Institute of CPAs.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

With nearly \$6 billion in assets under advisement, Laird Norton Wealth Management is the Northwest's premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 700 individuals, families, business leaders, private foundations and nonprofit organizations.

801 Second Avenue, Suite 1600, Seattle WA 98104 206.464.5100 800.426.5105 lairdnortonwm.com

DISCLOSURE

All investments involve a level of risk, and past performance is not a guarantee of future investment results. The value of investments and the income derived from them can go down as well as up. Future returns are not guaranteed and a loss of principal may occur. All investment performance can be affected by general economic conditions and the extent and timing of investor participation in both the equity and fixed income markets. Fees charged by LNWM will reduce the net performance of the investment portfolio.

The information presented herein does not constitute and should not be construed as legal advice or as an offer to buy or sell any investment product or service. Any opinions or investment planning solutions herein described may not be suitable for all investors nor apply to all situations. All opinions expressed are those of Laird Norton Wealth Management and are current only as of the date appearing on this material.

Any accounting, business or tax advice contained in this presentation (or communication, including attachments and enclosures) is not intended as a thorough, in-depth analysis of specific issues, nor a substitute for a formal opinion, nor is it sufficient to avoid tax-related penalties.

Some investments may not be publicly traded and they may only allow redemptions at certain times conditioned on various notice provisions and other factors as more fully described in the related offering and subscription documents provided at the time of the investment. Due to the nature of these types of investment funds, hedge funds, fund of funds, and similar partnership-like investment vehicles, they should be considered illiquid. In addition to restrictions on redemption, they often include holdback provisions that may delay a full redemption for several months or longer. There is no guarantee that the amount of the initial investment can be received upon redemption. Due to the nature of the tax reporting that may be available from these types of investments, clients should expect to extend the filing of their tax returns.

A benchmark is an unmanaged index, and its performance does not include any advisory fees, transaction costs or other charges that may be incurred in connection with your investments. Indices are statistical composites and are shown for informational purposes only. It is not possible to invest directly in an index. Indices are unmanaged and are not subject to management fees. Any benchmark whose return is shown for comparison purposes may include different holdings, a different number of holdings, and a different degree of investment in individual securities, industries or economic sectors than the investments and/or investment accounts to which it is compared. Comparisons of individual account or portfolio performance to an index or benchmark composed of indices are unreliable as indicators of future performance of an actual account or portfolio. Actual performance presented represents past performance net of investment management fees unless otherwise noted. Other fees, such as custodial fees or transaction related fees may not be reflected in the actual performance results shown.

Certain information herein has been obtained from public third party data sources, outside funds and investment managers. Although we believe this information to be reliable, no representation or warranty, expressed or implied, is made, and no liability is accepted by Laird Norton Wealth Management or any of its officers, agents or affiliates as to the accuracy, completeness or correctness of the information herein contained. In addition, due to the nature of an investment or the date of the creation of the attached presentation, some values shown or used in the calculation of performance may be based on estimates that are subject to change.

All data presented is current only as of the date thereon shown. Laird Norton Wealth Management is comprised of two distinct entities that may offer similar services to clients. Laird Norton Trust Company is a State of Washington chartered trust company. Its wholly owned subsidiary, Laird Norton Tyee Asset Strategies, LLC, is an Investment Advisor registered with the Securities and Exchange Commission. Such registration does not imply any level of skill or expertise.