Managing Your Equity Compensation In Volatile Markets

By Kristi Mathisen, JD, CPA, PFS

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

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.

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#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.

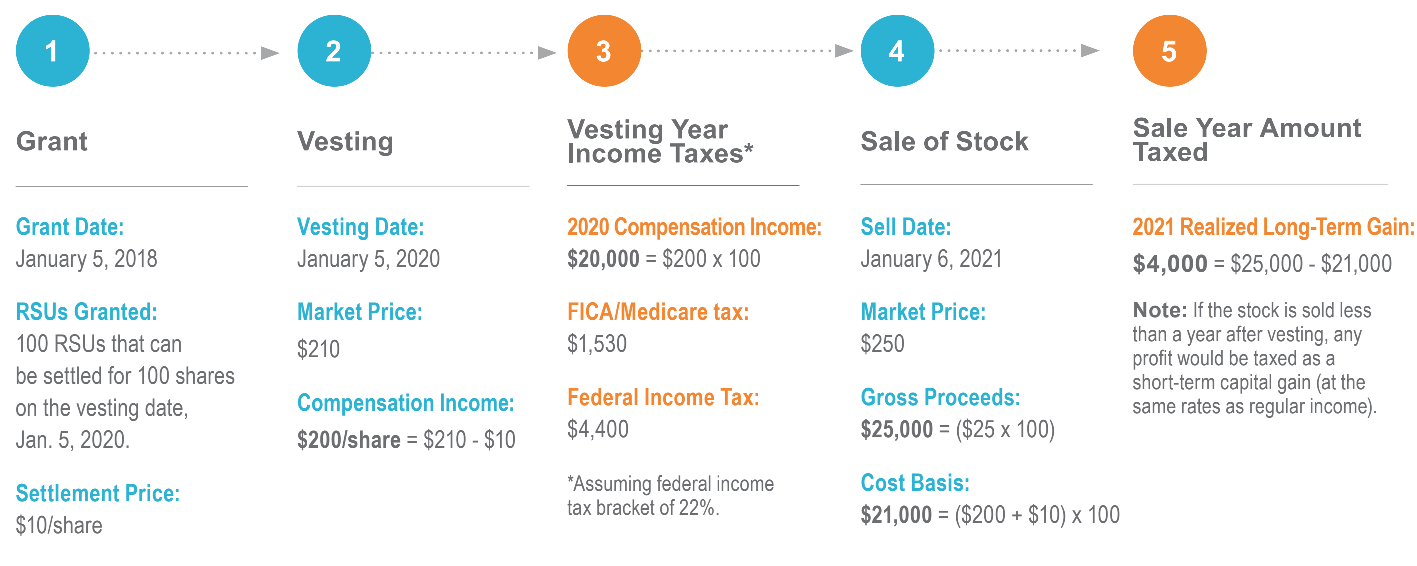
With stock options, you do not own stock until you exercise the option to purchase. If the market price of the stock drops below the option's guaranteed purchase price (the "strike" price), the option can expire worthless.

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.

#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).

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.

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.

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) — granted to contractors, suppliers, investors, as well as employees.
Taxes: Upon exercise of NSQOs, 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).

About the Author

Kristi Mathisen, JD, CPA, PFS is managing director, 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 CPA and the American Institute of CPAs.

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