A Tech Employees Guide to RSUs, Stock Options, and ESPP's

by Levi Sanchez CFP®, BFA™

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Introduction:

Equity compensation plans can often be confusing, but highly lucrative benefits that tech companies offer their employees in the increasingly competitive hiring environment. The key to maximizing these benefits is to first understand how they work. This comprehensive guide will outline their benefits, tax consequences, and particular items of interest as it relates to stock options, restricted stock units, and employee stock purchase plans. All three being the the primary forms of equity compensation plans available today. I hope you find this guide informative and insightful. For more detailed information or, to develop a plan unique to your situation, goals, priorities, and concerns, schedule a free consultation with us today.

About the Author:

Levi Sanchez, CERTIFIED FINANCIAL PLANNER™, BEHAVIORAL FINANCIAL ADVISOR™ and Co-Founder of Millennial Wealth, a fee-only financial planning firm for young professionals and tech industry employees. He's an avid sports fan, personal finance and investing geek, and enjoys a great TV show or movie. His mission is to help educate his generation about better money habits and provide financial planning services to those who want to start planning for their future!

Stock Options

Key Terms to Understanding Stock Options

In order to understand how stock options work it’s important to recognize some universal terms.

Grant Date: Typically, a company offering employee stock options will have grant dates for employees. Ownership is rarely given to employees immediately upon hire. Rather, they typically require a certain amount of time at the company before they're granted.

Vesting: The date that the granted options "vest", you gain full control of the options. Once vested, you're able to choose when to "exercise" the right to buy your employer's stock. The vesting schedule differs among employers, with some using a cliff schedule, and others using a graded schedule. A cliff schedule would vest in full after a certain period of time, typically 3 to 5 years. A graded schedule would vest in chunks over a set period of time, say annually over a 5 year period.

Exercise Price: The price at which you have the right to buy the stock once it's vested. What makes stock options valuable, aside from the fact that it’s additional compensation in the form of stock, is the "bargain element" received when you exercise. The bargain element is the difference between the exercise price and the market value of the stock at the time of exercising. For example, you may have a stock option that gives you the right to buy your employers stock at $10 per share, while the actual price of the stock is $20. That's an immediate profit of 100% (not factoring in taxes).

Expiration Date: The date (typically 10 years from the grant date) at which your right to the stock options expires. If you don't exercise your options prior, you'll lose the right to buy the stock options all together.

Types of Employee Stock Options

1. Non-Qualified Stock Options (NSO)

- NSO's are generally offered to non-executives or key persons of a company.
- Granting of NSO's is not a taxable event.
- Ordinary income tax is owed at the time of exercise on the "bargain element", or the difference between the exercise price and the stock’s current market price.
- When the stock is eventually sold, you pay capital gains taxes depending upon the amount of time you held the stock after exercising it. If held for less than 1 year you'll owe ordinary income tax. If held for longer than 1 year, you'll pay the long-term capital gains tax rate (0%, 15%, or 20% depending on your income).

2. Incentive Stock Options (ISO)

- Granting of ISO's is not a taxable event.

- Exercising ISO's is not a taxable event. However, the dreaded AMT tax can apply to the "bargain element" of the exercised stock. The AMT tax is the alternate tax table used to tax income above a particular threshold from items such as ISO’s. It’s important to consider the AMT tax before exercising a large amount of ISO’s by consulting with a tax professional.

- When the stock is eventually sold, you pay the respective capital gains tax according to the amount of time the stock was held after exercising it. If held for less than 1 year you'll owe ordinary income tax. If held for longer than 1 year, you’ll owe the long-term capital gains rate. However, ISO’s are unique in that they require at least two years since the stock was granted to qualify for long-term capital gains.

How Do Stock Options Fit into My Financial Plan?

If you're fortunate enough to receive stock options as a benefit through your employer, it's important to determine how they'll fit into your overall financial plan. In order to maximize their benefits, you must to consider tax consequences, the stock's value, and the level of risk you're willing to take.

Tax Consequences

Taking advantage of long-term capital gains rates as opposed to ordinary income can help reduce the overall tax burden of stock options - that is if you're willing or able to expose yourself to a concentrated position for a longer period of time. The difference between paying ordinary income tax and long-term capital gains can be significant, especially for individuals in the highest marginal income tax brackets. NSO's are recognized as ordinary income once exercised. If the bargain element is great enough, this can push unsuspecting individuals into a higher tax bracket.

Weighing the pros and cons of doing so is an important consideration to make when exercising NSO's. ISO's can potentially expose you to AMT taxes, the parallel tax code. The way the IRS views ISO's is they're essentially giving away the bargain element (the difference between exercise price and current market price of the stock) tax-free. In order to ensure people pay taxes on that compensation, they include it in the AMT tax. Consulting with a tax advisor or financial planner prior to exercising a substantial amount of ISO's can help you navigate and mitigate the AMT tax.

The Stock's Value

When determining whether to exercise stock options, you want to determine the future prospects of the stock itself. If the current market value of the stock is similar to or less than the exercise price, you probably won't be exercising the option.

Depending on the expiration date of your options, you may have time to wait and see how the stock performs. Remember, once the stock option is vested, you maintain the right to purchase the stock at the exercise price until the expiration date. If the stock performs better and rises above your exercise price, then you may consider exercising, especially if the long-term growth prospects are favorable.

Concentrated Stock Risk

With both types of stock options there lies a common concern: concentrated stock risk. While stock option plans can create substantial wealth, what's important to consider is the risk created when that wealth arises. Individuals end up with concentrated stock positions oftentimes as a result of equity compensation plans. Not only do they rely on the company for income, health benefits, etc, but a large portion of their net worth ends up in the company stock. If something were to happen to the company, it could be catastrophic for an individual with concentrated stock risk.

The key is to diversify. Oftentimes, there remains an emotional connection to the stock. The company you've worked hard for has rewarded you with ownership and it's built great wealth! It's a natural reaction. However, when it comes to investing you have to try and separate the emotional connections, from what you're truly presented with as it relates to your financial plan and goals. For example, what if your financial advisor recommended you buy one stock that represents 50% of your net worth? Not that they would ever do that, but it represents the same situation from an analytical perspective. Whether the stock was bought using stock options or cash in a brokerage account, having 50% of your net worth tied up in one stock represents a substantial risk.

Diversification doesn't necessarily mean you'll earn less returns either when compared to a concentrated stock position. What it does mean - is your investment returns are being maximized for a given level of risk. Having a stock sell-off plan that manages the tax consequences in addition to diversifying over time is a key component of a financial plan that includes stock options.

Restricted Stock Units

What is an RSU?

A restricted stock unit (RSU), is stock given to an employee by a company as an incentive for the employee to stick around. Which means the company is giving ownership to employees to share in the profits of the firm. This can be a win-win for both employer and employee. Longer employment typically leads to higher productivity, which ultimately leads to higher profitability Higher profitability ultimately increases the stock price which the employee then benefits from as well.

Grant Date vs Vesting Date

RSU's have two main dates that recipients should be aware of: 1. The grant date, and 2. The vesting date. The grant date is when your company pledges shares of the company to you with the promise to give these shares to you at a further date (vesting date). Hence the "restricted" part. Shares are "restricted" subject to a vesting schedule and employees can't touch them until they've vested.

The vesting schedule is commonly based on the length of employment or performance goals. The stock could potentially vest all at once or, a percentage could vest over a period of years. The date that the shares vest is the "basis" used for computing tax consequences. It's treated just as if you had bought the stock on the same date, in terms of computing tax when the stock is eventually sold. However, Uncle Sam needs his portion of this compensation, and on the vesting date, the market value of the shares is included as part of your income.

Tax Considerations

Let's use an example to illustrate the tax implications of vested RSUs. On July 1st, 100 shares of XYZ company stock vests. On this date, each share is worth $50. The total market value of these shares is $5000 (100 shares x $50 = $5000). The $5000 must be included as ordinary income on the recipient's Form W-2. Meaning the compensation is subject to withholding taxes such as social security, Medicare, and state and local taxes in addition to federal income taxes.

Your employer may or may not give you all or a few of the following options to pay withholding tax on the vested shares.

1. Cash transfer: Use cash to pay the withholding tax. No shares are sold.

2. Sell to Cover or Net Issuance: Both involve selling vested shares of stock to cover the cost of the withholding tax. Remaining shares are given to the recipient.

3. Same day sale: Sells all vested shares and uses part of the cash proceeds to cover the withholding tax. Remaining cash is given to the recipient.

Unfortunately, there isn't a cookie cutter solution to managing RSUs on the vesting date, however, we'll cover a few of the different situations when we review planning opportunities at the end of this section. While nothing can be done to avoid the inevitable tax on RSU's once they vest, the good news is the shares do become 100% yours. The last tax consideration to consider is what occurs when you sell the stock. If the stock is sold prior to one year after vesting, the gain (increase in value since vesting) will be taxed at ordinary income tax rates (your income tax bracket). If held longer than one year, the gain will be taxed at the more favorable long-term capital gains rates (0, 15, or 20% depending on your income tax bracket).

What to do with my RSU's?

Now that we've covered the basics in regards to RSUs, we can dive into the various planning scenarios surrounding them. The most common question RSU recipients have is: Should I hold, sell, or diversify my stock? In an attempt to answer this question, please keep in mind every person's situation is different and several factors must be considered when making a decision.

You may consider holding your vested shares of company stock if you believe the company is on a growth trajectory. The first company that comes to mind is Amazon, and it's massive growth over the past 20 years. Employees who decided to sit on their stock in the early years have more than likely become very wealthy. However, with any concentrated position, it presents significant risk. Having "all your eggs in one basket" inherently increases the risk you're taking with investments. It can seem an investment is less risky because you know the company well, and work there, but it doesn't change the matter of fact that concentrated positions inherently involve more risk than a multitude of different stock positions. If RSUs are continually being granted, you may consider selling a portion of the stock and diversifying elsewhere, knowing that you'll be receiving more company stock in the future.

Recapping on the tax implications, if you decide to hold company stock, remember GAINS are taxed at better rates if the stock is held for longer than a year. For example, if you have stock you've held for 9 months that's appreciated in value by 15%, that 15% gain will be taxed at your ordinary income tax bracket if sold. Whereas, if you waited an additional 3 months to sell the stock, the 15% gain would be taxed at the lower long-term capital gains bracket, potentially saving a lot of in taxes.

Secondly, you may decide to sell the vested company stock immediately, or shortly thereafter. This could be a consideration for the mere fact of diversifying, or potentially to store up on cash for liquidity. Since nothing can be done about the income taxes paid on RSU's, if you sell immediately upon vesting, the short-term capital gains will be very minimal if nothing at all, and the proceeds could be used for other financial goals like buying a home, funding a 529, or contributing to a Roth IRA.

Key Takeaway

RSUs are a great addition to compensation that employers can potentially give their employees. The key things to remember are the income tax consequences, and the potential to build up a fairly risky portfolio if the stock continues to accumulate. While there's nothing wrong with concentrated positions in company stock, it is important to be aware of the risk you’re assuming while maintaining it.

Employee Stock Purchase Plans

How Employee Stock Purchase Plans Work

All ESPPs have a few things in common. First, an employee must elect how much to contribute. Typically its the lesser of 15% of gross income or $25,000 annually. Contributions are after-tax payroll deductions. Meaning, contributions come directly from your paychecks, but won’t provide any tax benefits.

The major benefit of ESPPs is they allow employees to buy the company's stock at a discounted price. Most often at a discount of 10-15% of the market value! That means you immediately have a positive return on your investment when participating in an ESPP.

Key Terms

Offering Period

Employees can elect to participate during the offering period. Depending on your company’s unique plan, offering periods may overlap or run consecutively.

Contributions are accumulated in a separate account, but company stock is not bought during this period, funds are merely accumulated until the purchase date.

Offering Date
The first day of the offering period. Contributions begin on this date and it's used for future tax purposes when calculating the discounted price at which to buy company stock.

Purchase Date
At the end of the offering period is the purchase date. On this date, company stock is bought for all participants at the discounted price.

One caveat to be aware of is the "look back provision". Most companies include this benefit. Instead of purchasing the stock at the purchase date market price, the plan will purchase the stock at the lesser of either the offering date or purchase date market price.

For example, if ABC company's stock was $100 on the offering date and $120 on the purchase date, the plan will use the lesser ($100) to calculate the discounted purchase price.

This is a huge advantage. It means you're receiving more shares at a better price. Shares become accessible to employees the day after the purchase date.

Example for ABC company ESPP:

The plan offers employees to purchase ABC stock at a 15% discount. For this example, let's assume an employee has contributed a total of $10,000 during the offering period.

Offering date market price of ABC stock: $100 per share

Purchase date market price of ABC stock: $110 per share

Your purchase price: $85 (lesser of offering date price and purchase date price, $100 * 15%)

Total shares purchased: 118 (rounded up for the sake of simplicity)

Gain: $110 (current market price) - $85 (discounted purchase price) = $25 per share.
$25 per share * 118 shares = $2,950 profit. This is equal to a **29.5%** gain. Not bad at all. Let's test what happens when the stock price is less on the purchase date than the offering date.

Offering date market price: $100 per share

Purchase date market price: $90 per share

Your purchase price: $76.5 (lesser of offering date price and purchase date price, $90 * 15%)

Total shares purchased: 131 (rounded up again)

Gain: $90 (current market price) - $76.5 (discounted purchase price) = $13.5 per share
$13.5 per share * 131 shares = $1,768.50 profit. This is equal to a **17.69%** gain. Again, not bad. Even when the stock price goes down after the offering date, because you're purchasing at a 15% discount, you're still locking in a positive gain. Extrapolate this over a longer period of time and you can see how it can be used as a great wealth building tool.

When to sell shares?

The "downside" of an ESPP is that employees tend to hold their shares for too long. If you participate in a plan over a long period of time, without selling any stock, it's likely a large part of your net worth will be concentrated in the company's stock. While buying and holding the company's stock may have helped build wealth over time, it can also lead to disastrous outcomes.

Diversification is still key to maintaining wealth. Understandably, employees tend to get emotionally attached to their company's stock then become overconfident and lose sight of what the real risks are. A concentrated position does not maximize an investor's returns to the level of risk they are taking. Using diversification, you can still earn solid returns that may or may not equal the performance of company stock, but it will greatly reduce the risk.

The worst possible scenario is building up a million dollar portfolio of company stock only to have an event occur that sends the stock plummeting. It can and will happen to companies. The best defense is to keep emotion out of the equation and diversify your investments.

A great strategy with ESPPs is to sell vested shares immediately after the purchase date. By doing so, you're ensuring a positive return and the ability to diversity.

Tax Consequences

Calculating the tax consequences of selling ESPP shares can be complicated. Depending on the length of time you hold the shares, you either have qualifying dispositions or disqualifying dispositions.

- **Qualifying Dispositions:** For stock held 2 years after offering date and 1 year after purchase date. The discounted percentage is taxed as ordinary income and the remainder of stock is taxed at long-term capital gain rates.

- **Disqualifying Disposition:** The majority is taxed as ordinary income.

Even with the favorable tax treatment of holding shares for a longer period of time, in most cases, it's better to take the profits and put the cash to work in a diversified portfolio.

Key Takeaway

Participating in your ESPP plan is a no-brainer if you have extra cash flow available to invest. The automatic 15% gain in a short period of time is hard to beat elsewhere. Of course, ensuring you're contributing roughly 15% to your retirement plans, covering debt payments and funding other short-term goals should remain a priority. But once these are funded, an ESPP should be at the top of your list, if available.

Conclusion

Regardless of which equity compensation plan(s) you have access too, they're all great wealth building tools. As I've stated in this guide, the key is figuring out how they fit into your overall financial plan. Everything in your life works in tandem and should be viewed holistically. If you reduce the cash flow you're setting aside for a home down payment or investment property to increase ESPP contributions or exercise stock options, how does that affect your taxes? How does it impact your timeline to afford the downpayment? That's where a comprehensive financial planner can help model specific outcomes, maximize decisions and, MOST importantly, help articulate the goals and values that help you lead your best life! To get started, schedule a free consultation with us today.