Guide to Employee Stock Compensation

Complex Rules, Valuable Decisions

WRITTEN BY

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PLENTY OF UPSIDE, LOTS OF DECISIONS

Stock incentive compensation plans are significant employee benefits used by both public and private firms. They are a great way to compensate valuable employees, while aligning employee incentive structures with those of firm shareholders.

Unfortunately, employee stock compensation plans are complex due to their many rules. They are difficult for most employees to fully understand, especially when it comes to **maximizing value**, **minimizing income taxes** and **managing risks** inherent with owning employer stock.

This guide provides a basic overview of some of the more frequently used types of employer stock compensation plans, many of their key attributes, and issues to consider when deciding how much company stock exposure to maintain. Since there are often significant dollars in play, poor decisions and missed opportunities can be damaging.

After reading the guide you should have a better understanding of:

- ✓ Why firms use company stock to compensate employees
- ✓ The more common types of stock compensation plans
- ✓ The key characteristics of these stock compensation plans
- ✓ Decision making complexities within employer stock compensation
- ✓ Behavioral biases that impede employees from making their best decisions regarding employer stock compensation

This is a complex area that requires an understanding of income tax issues and portfolio management. Don't hesitate to seek help from an expert with tax and investment experience to assist you in evaluating decisions for your employee stock incentive compensation.

WHY FIRMS OFFER STOCK BASED COMPENSATION

This part is fairly simple. Companies issue stock compensation for a few basic reasons:

1. **Reduce Cash Outflows** - Using stock compensation reduces cash expenditures on employee compensation, so cash can be available for other purposes. Even though firms don't experience a cash outlay, employers still receive a tax deduction for the compensation expense.
2. **Align Management and Shareholder Incentives** - Stock compensation plans, in theory, align management incentives with shareholder incentives.
3. **Attract and Retain Employees** - Firms use stock and executive compensation plans to attract and retain valuable employees. Stock provides potential financial upside and can make up for lower levels of cash compensation when employees are evaluating multiple job opportunities.

TYPES OF EMPLOYEE STOCK COMPENSATION

The most common types of employee stock incentive compensation plans include:

1. **Employee Stock Options**
   - **a. Non-qualified Stock Options**
   - **b. Incentive Stock Options**
2. **Restricted Stock**
   - **a. Restricted Stock Awards**
   - **b. Restricted Stock Units/ Performance Stock Units**
3. **Employee Stock Purchase Plans**

EMPLOYEE STOCK OPTIONS (ESOs)

Employee Stock Options provide employees the right, but not the obligation, to purchase company stock at a pre-established price known as the exercise price.

Imagine that when you join your company their stock is trading at a price of $11.25 per share. As part of your compensation package the firm may offer you employee stock options that allow you to purchase their stock at some future date at that same $11.25 price. This price is referred to as the grant price, exercise price or strike price – each of these terms is interchangeable. Your hope, of course, is that the stock will rise in price and you will profit. But you won't be able to exercise your option to buy the company stock until you have worked at the company for a certain amount of time, also know as the vesting period.

Once you reach that time milestone and the options vest, you will then be able to exercise them to buy the company stock. If the stock is trading at $14.25 you can exercise each option to buy a share of stock at $11.25 and then sell the stock at $14.25. So for each option you own and exercise, you earn $3.00. If the stock price had dropped to $9.50 and you had the option to buy at $11.25, you would choose not to exercise as you would have to pay $11.25 for shares worth only $9.50 resulting in a loss of $2.75 per share.

Expiration of Employee Stock Options

Typically employee stock option grants expire after 10-years if not exercised, however each unique company may have its own expiration rules so it is important to refer to your firm's plan document.

Two Types of Employee Stock Options

1. Non-qualified stock options (NQSOs)
2. Incentive stock options (ISOs).

Typically ISOs are issued to only the most senior executive employees, so the vast majority of employee stock option grants are of the NQSO variety. A chart of their key attributes follows:

NQSOs	Key Attributes	ISOs
Employees, Directors, & Consultants	**Allowable for Grants**	Employees Only
Yes	**Transferability of the Option**	Only at Death
None	**Annual Grant Limit**	$100,000, based on vesting year
Typically 10 years from grant date	**Expiration**	Typically 10 years from grant date
Exercise	**Income Tax Triggering Event**	Sale of Stock
Income at exercise – ordinary rates (plus payroll tax) If stock then held, income at sale – capital gains rates apply	**Income Tax Treatment**	If stock held two years from grant date and one year from exercise – long-term capital gains rate
No	**Potential Alternative Minimum Tax Issues**	Yes
Yes	**Income Tax Withheld at Exercise**	No

Tax Treatment of Employee Stock Options

NQSO Income Tax Treatment - As you can see in the chart above there are several nuances between NQSOs and ISOs, but the primary difference between them is how they are treated for income tax purposes. For NQSOs income generated from the difference between the grant price and market price at exercise (the $3 in the example above) is taxed upon exercise and at ordinary income tax rates. This is a less favorable income tax treatment than ISOs receive.

ISO Income Tax Treatment - For ISOs that same income is not taxed until the sale of stock purchased with the options. And in the case of ISOs, depending upon how long the stock is held income may be taxed at lower long-term capital gains rates.

Downside of Employee Stock Options

If the firm's stock price does not rise above the exercise price, the options could become worthless. In such instances the option grants may not accomplish management's goal of fairly compensating and retaining high-value employees. For this reason more companies are beginning to use Restricted Stock Awards and Restricted Stock Units/Performance Stock Units rather than/or in addition to Employee Stock Options. Restricted Stock has intrinsic value regardless of whether the price of the stock rises or falls, unless in an extreme case of the stock price declining all the way to zero.

Restricted Stock

Many companies use restricted stock to compensate employees. It provides direct equity ownership rather than the option of equity ownership, as in the case of employee stock options.

Restricted stock can be issued in a couple of ways; Restricted Stock Awards or Restricted Stock Units.

Restricted Stock Awards (RSAs)

A Restricted Stock Award is actual unregistered stock in the corporation that is non-transferable. It becomes transferable upon vesting through the passage of time and/or reaching certain performance metrics. Unlike with employee stock options which may never have value if the firm's stock price does not exceed the exercise price, restricted stock has intrinsic value.

Potential Tax Benefit of Restricted Stock Awards

As an added potential income tax strategy, the IRS code includes section 83(b) that allows receivers of restricted stock awards to elect to pay ordinary income taxes at the grant date rather than at the future vesting date. This allows for favorable capital gains treatment on the future gains rather than ordinary income tax rates on those same gains if an 83(b) election is not made.

It's important to note that all is not rosy with an 83(b) election as there are some risks.

1. **Employment Termination before RSA Vesting** - If you leave your company before the RSAs vest you cannot sell the stock and you can't get back the income taxes that you have already paid to the IRS, and
2. **Stock Price Decline** - If the stock drops in price you may have paid excess income tax based on the grant price.

A section 83(b) election is typically best used for Restricted Stock Awards of pre-IPO firms with very low stock valuations.

Restricted Stock Units (RSUs)/Performance Stock Units (PSUs)

These are similar to restricted stock awards, except that the units are not actual stock. Stock is received in exchange for the units upon vesting of the RSU/PSU. Unlike restricted stock the units do not have voting rights and typically do not receive dividends. Once the units are

exchanged to actual stock shares, the holder receives voting rights of the appropriate share class and receives dividend payments, if any. RSUs vest based on a period of time, while PSUs vest based on the firm hitting certain performance targets.

The following chart depicts some of the key attributes of Restricted Stock and RSU/PSUs.

Restricted Stock	Key Attributes	**RSUs/PSUs**
Employees, Directors, & Consultants	**Allowable for Grants**	Employees, Directors, & Consultants
Non-transferable	**Transferability of the Option**	Non-transferable
None	**Annual Grant Limit**	None
At Vesting	**Income Tax Triggering Event**	At Vesting
Yes	**Dividends**	Optional, at company's choice
Yes	**Voting Rights**	No
Ordinary income tax rates for the value at vesting (plus payroll taxes), capital gains treatment on income after vesting	**Income Tax Treatment**	Ordinary income tax rates for the value at vesting (plus payroll taxes), capital gains treatment on income after vesting
No	**Potential Alternative Minimum Tax Issues**	No
Typically	**Income Tax Withheld at Exercise**	Typically
Yes, IRS section 83(b) election is available	**Early Exercise Election (reasonable option typically only for pre-IPO employees)**	No

Employee Stock Purchase Plans (ESPPs)

An ESPP allows employees to buy company stock at a discount to its market value. They are a great benefit for employees to earn extra income.

ESPP Payroll Deduction Elections

Typically employees pay for the stock through after-tax payroll deductions. At the beginning of a period you elect the dollar amount of employer stock you want to buy during that period. Then the payroll department manages the process on your behalf.

ESPP Discounts

The discount percentage depends on the unique company plan, but often ranges from 5% to 15%. In addition to the discount percentage, ESPPs also often include a provision that allows the stock to be purchased at the lower of the price on the offering date or the actual purchase date. This provision, when the stock price has been rising, can greatly increase the total discount received.

Example of ESPP Discount Calculation

Assume that through its ESPP plan a firm offers a 15% discount on its stock. On the ESPP offering date the firm's stock price is $10 and the firm will make a purchase on behalf of the ESPP six months later when then stock is trading at $12. If the ESPP has a provision to purchase at the lower of the offering date or purchase date price, in this case each share of stock will be $10 less the 15% discount for a net price of $8.50. The stock is trading on the open market for $12 so the $3.50 discount is actually nearly 30%, a significantly greater discount than the 15% offered in the ESPP.

IRS ESPP Related Income Tax Rules

The IRS caps the amount of each employee's annual ESPP purchases to $25,000 market value. The market value is determined on the offering (grant) date when a maximum number of shares that can be acquired for the year is established.

If the stock price on the offering date is $10/share then with a full election of $25,000 you could buy 2,500 shares during the year. So with a 15% discount, you would pay $21,250 for $25,000 market value stock if the stock price remained flat at $10 for the entire year. Since stock prices tend to fluctuate throughout the year, the price paid may not be as simple as the above example. Due to potential complexity, firm payroll departments typically manage your purchases so that you do not exceed the $25,000 IRS maximum allowed.

Favorable Income Tax Treatment of ESPP Income

Income taxes are deferred until you sell the stock. The discount you receive versus the stock market value at purchase (the $3.50 in the example above) is taxed as ordinary income (just like your wage income) and the gains on the stock beyond the market value on the purchase date are taxed at capital gains rates. For preferable long-term capital gains rates you would need to hold the stock for two years past the beginning of the offering period, and for one year after the date of purchase.

DECISION COMPLEXITY WITH REGARDS TO STOCK COMPENSATION

If you've read this far, you can see that there is a bit of complexity to the rules governing the various types of stock compensation plans. When it comes to making good decisions it is important to understand the rules, but also paramount to consider your personal/family goals and objectives.

The following are some questions you may want to consider before making decisions to exercise options, participate in the ESPP, or sell company stock that you own:

DECISION MAKING - QUESTIONS TO CONSIDER	
1)	What's most important to you regarding your firm stock holdings; tax minimization, stock appreciation, risk management, liquidity needs or something else?
2)	As an executive, are you required by the firm to maintain a certain level of employer stock in your portfolio? If so, how much?
3)	Is there a company imposed lock-up period due to a recent public offering?
4)	Are there frequent limited trading windows announced by the company that will need to be worked around at times of liquidity needs?
5)	Where does the company stock value fit in your financial plan; long-term spending, short-term spending, financial legacy, or charity?
6)	What does your career trajectory look like? Do you expect significant future stock compensation awards?
7)	What's your plan for selling the employer stock or exercising stock options you hold? Why is that your plan?
8)	If you didn't work for your company, how much of your portfolio would you allocate to its stock?
9)	Do you fully understand the terms of the restricted stock/stock option compensation plan(s) to effectively strategize around the plan nuances?
10)	Do you understand how the various types of stock and executive compensation are taxed and how to best manage the income tax burdens?

Two Decision Making Issues

In the context of your unique life and financial goals, managing your employer stock compensation really boils down to two issues:

1. **Risk Management** - How much risk does your employer stock add to your broader portfolio?, and
2. **Income Tax Efficiency** - How best to minimize income taxes?

The two issues often have trade-offs. For some strategies in order to minimize income taxes you have to accept additional risk with the company stock. One solution to managing the increased risk from holding your company stock may be to reduce risk in positions held in your broader investment portfolio.

The following paragraphs expand a bit more on risk management. Income tax optimization strategies tend to be unique to the individual's income tax situation and are often best addressed through a conversation with your tax professional or financial advisor.

Portfolio Risk and Employee Stock Compensation

Risk, in the context of employer stock, is defined as

1. **Overconcentration Risk** – Holding too high a percentage of employer stock in your overall investment portfolio, and/or
2. **Volatility Risk** – Whether holding the employer stock increases, decreases or has no impact on the volatility of your overall investment portfolio.

Overconcentration Risk

This is best addressed through an example.

Let's say John is early in his career and receives stock options valued at $100K at the time they vest three years after the grant date. When John started his job three years earlier he had $60K of student debt and virtually no savings. Now, three years later his student debt is down to $50K and he has saved about $15K in an emergency savings account. His net worth is about $65K when taking into account his savings of $15K, and his $100K of company stock less $50K in student debt.

Yet John owns $100K of company stock, representing 154% of his total net worth. If his employer's stock falls significantly, the decline in his net worth will be also be significant. John has an overconcentration of his employer's stock and should consider selling most of the stock to purchase more diversified assets. By diversifying out of company stock John can reduce risk specific to his employer, such as the loss of a major customer or supplier relationship, a significant lawsuit, losing sales to a competitor, etc.

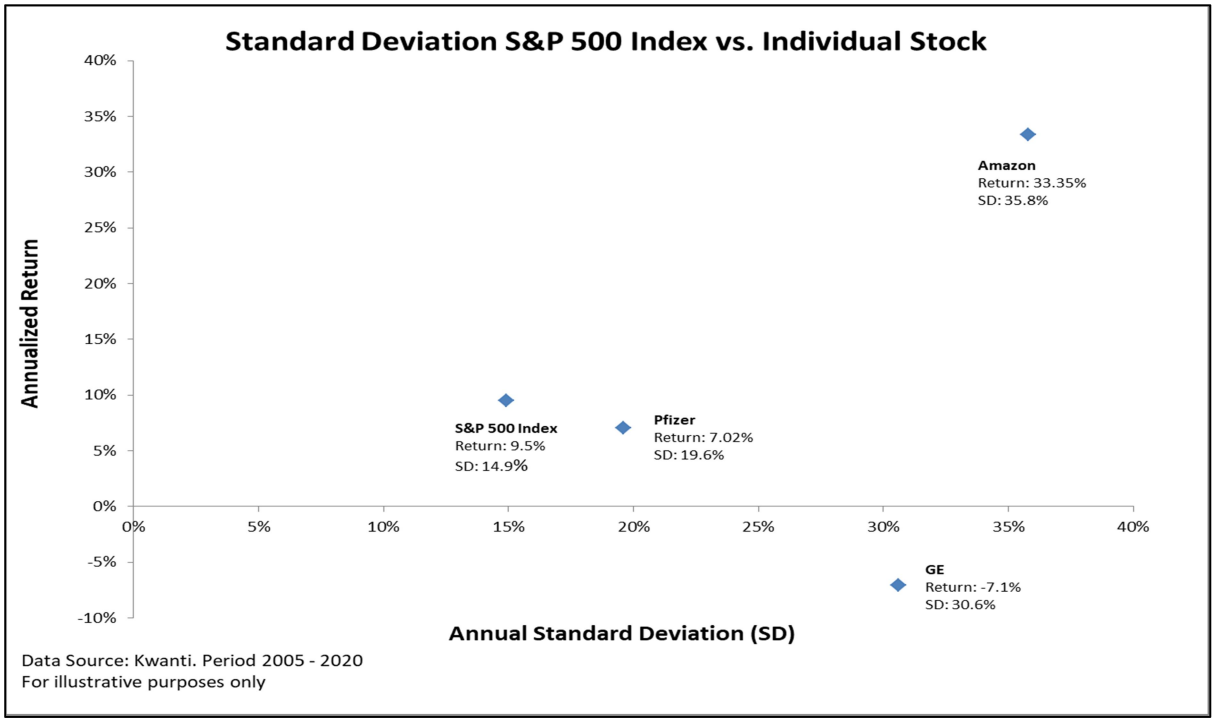
The story of Enron Corporation is a great real life example of why you may prefer not to hold an overconcentration of employer stock. Fortunately few firms will experience the rapid decline of Enron's stock price, which fell from about $90.00 in late August 2000 to $0.00 just 17 months later in January 2002.

This was devastating to the net worth of any Enron employee that held an overconcentration of company stock in their portfolio. Not only did they lose a great amount of their net worth and retirement savings, they also lost their jobs. More recently, consider the stock prices of firms that are unexpectedly declaring bankruptcy as a result of the Covid-19 pandemic.

Volatility Risk

The chart below shows for the past 15 years the annual return and standard deviation of the S&P 500 index, Amazon stock, Pfizer stock and GE stock. Standard deviation is one measure of risk used by investment professionals; the higher the standard deviation, the more volatile (risky) the stock. You can see that each of the individual stocks is more volatile than the broadly diversified S&P 500 index. By holding too much of any of these individual stocks, or perhaps your employer stock, you may be adding unwanted volatility (risk) to your investment portfolio.

Of particular interest is that GE stock had a -7.1% annual return over the 15 year period, but with volatility that came close to matching that of Amazon's. A key concept of good investing is that investors should be rewarded for the risk they take. This was clearly not the case with GE stock over the 15 year period from 2005 – 2020.



Risk Tolerance and Risk Capacity

It's always important to manage risk within the constraints of your personal risk tolerance and capacity to take on risk. Risk tolerance measures your emotional ability to handle risk. Risk capacity measures your financial ability to accept risk based on the upside potential of your human capital and/or your current net worth versus expected lifetime spending.

Income Tax Management

Depending upon your unique situation, there may be various income tax strategies available. Planning in advance to minimize income taxes can be helpful to achieve better results when exercising employee stock options and/or selling employer stock. The various strategies that can be used are complex and beyond the scope of this guide. Please consider consulting with your tax or financial advisor to make a plan.

BEHAVIORAL BIASES IMPACT DECISION MAKING

It's important to consider that as human beings almost all of us have some blind spots in our decision making processes. Behavioral finance is a nascent, but quickly growing area of academic research that defines emotional and behavioral biases that can negatively impact our objective decision making. When it comes to decisions around employer stock based compensation, academic research suggests the following biases can impede objectivity:

1. **Overconfidence Bias** - Due to the intimate knowledge that employees have of their firms, they often are overconfident of the potential outcomes and thereby tend to overvalue their company stock holdings.
2. **Status Quo Bias** - The easiest, but not always the best direction, is often to maintain the current status and make no decision at all. The band Rush has a great lyric in their classic hit song Freewill; "if you choose not to decide, you still have made a choice". It's important to understand whether inaction is your best available choice.
3. **Home Bias** - Many investors hold a high amount of their home country stock. In 2019/2020 US stocks comprise about 54% of world equity market value, yet most US investors include about 65% - 70% US stocks in their portfolios. During the same period Australian stocks comprise about 2% of the world investable stock value, yet Australians tend to hold about the same 65% - 70% in Australian stocks. The same home bias often leads employees to hold an overconcentration in their employer's stock.
4. **Endowment Bias** - As human beings, we often place more value on what we currently own than other assets available that we do not yet own.

Working with an objective and knowledgeable financial advisor can help to overcome these and other decision making biases.

CONCLUSION

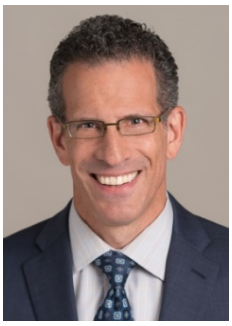
Throughout my career I have seen friends, family, clients and prospective clients make oversights with regards to their stock incentive compensation. One prospect came to me after their spouse allowed valuable stock options to expire without exercise. They left more than $30K on the table. Others have come to me with income tax returns prepared by tax advisors that made errors potentially costing their clients tens of thousands of dollars in overpaid income taxes. Fortunately, I was able to amend the tax returns and these folks received substantial refunds.

This guide intends to provide an overview, but certainly not exhaustive explanation of key considerations related to employee stock incentive compensation. As you can see the various types of plans and the rules surrounding them are quite extensive. And as is often the case with compensation and investment matters, income tax planning can play a significant role in maximizing the value of your holdings. The higher the value of stock compensation, the more it makes sense to develop a dynamic plan that meets your financial/life goals and minimizes income taxes.

Thanks for reading this guide. I'm hopeful that it is helpful in providing an understanding of some of the basics.

If you have questions about anything in this guide or think it would be helpful to have some expert advice, please feel free to reach out. BrightPath's contact information is on the following page.

ABOUT HARLAN FREEMAN



Harlan is the Founder and Principal Advisor at BrightPath Financial. His professional background includes experiences in corporate and personal finance with both large and small firms. He's held executive management positions, and also spent years honing his craft of advising business executives, professionals, entrepreneurs, retirees and their families. He is passionate about solving financial and life matters for his clients.

Immediately prior to founding BrightPath, he spent more than three years working with Trinity Financial Advisors. At Trinity, his clients invested assets ranging from under $1 million to more than $30 million. He assisted them on financial planning and tax planning matters, and also managed their investment portfolios. Harlan's clients have included legal, financial and healthcare professionals, and also current and former executives at well-known firms including Sears, Microsoft, Baxter Pharmaceuticals, Home Depot, Radio Shack, and Motorola.

Professional Credentials

Harlan is one of a small number of financial professionals that has achieved the three credentials:

- **Chartered Financial Analyst** (CFA)
- **Certified Public Account** (CPA)
- **Certified Financial Planner** (CFP®)

Education

- **University of Chicago Booth Graduate School of Business**
  MBA, Finance and Marketing
- **State University of New York at Binghamton**
  BS, Accounting

ABOUT BRIGHTPATH FINANCIAL

BrightPath Financial is a boutique financial advisor located in Chicago, Illinois.

For a limited, but exceptional group of clients, BrightPath's Principal Advisor provides comprehensive personal financial advice including investment management, financial and tax planning and income tax preparation.

You can learn more about Harlan and BrightPath Financial at www.BrightPathFinancial.com or (872) 249-9300 or hfreeman@BrightPathFinancial.com.