Understanding Employee Stock Options & Their Role in Your Net Worth

Employee stock compensation is a growing form of non-cash compensation that gives employees partial ownership in their company. Both startups and established companies may offer these compensation plans for various reasons. Given their rise in popularity, particularly within large technology companies like those in the San Francisco Bay Area, stock compensation programs have the potential to become a significant contributor to your overall net worth. The choices you must make can be complex, so a comprehensive tax strategy and long-term financial planning are essential.

TYPES OF EQUITY COMPENSATION PLANS

There are generally three types of equity compensation awarded to employees.

1. Stock Options
2. Restricted Stock Units
3. Employee Stock Purchase Plans (ESPPs)

Let's begin with **Stock Options**. Stock options provide you with the option to purchase a certain number of shares in your company at a pre-determined price. If the value of your company stock rises above that price and you exercise your right to buy shares, it can provide you with an immediate windfall. On the other hand, if your company stock falls below the value of your shares, you could end up with options that are worthless. Because options leverage the upside potential of your employer's stock share price, and most of the intrinsic value requires time to accrue, it is usually favorable to postpone exercising these options for as long as possible.

Generally speaking, plans include a vesting period, meaning you have to work for your employer for a minimum amount of time before you're allowed to exercise your options. They often also require that you buy shares within a certain number of years following vesting (usually within ten years).

Different types of stock options may be offered by different types of employers. For example, larger corporations will often issue Non-Qualified Stock Options (NQSO), while smaller firms might offer Incentive Stock Options (ISO). Your tax planning situation will be very dependent on the type of stock options you are offered.

These days, **Restricted Stock Units** (RSU) seem more common than stock options. Your employer awards you a set number of RSUs annually, each equivalent to one share. These vest to you in portions over a period of time, typically three to five years total. For example, if your employer offered 100 RSUs vested over four years, you would receive 25 each year for four years.

What makes RSUs a little bit tricky is that on the day each RSU vests and transforms into a share of stock, you must pay income tax on its full market value. In our simple example, if the 25 shares were worth $10 each, the market value would be $250, which would be considered taxable income for you. The company will withhold a mandatory amount of tax by cashing out an amount of shares equal to the income tax due, much like your regular paycheck.

Unlike stock options, RSUs generally have *some value*, whereas stock options can become worthless if the price of the stock falls below your option price. You can also choose to sell your new shares right away with *no additional tax ramifications*. In some situations, this is a fine opportunity to reinvest that compensation and diversify your personal net worth. After all, the company will be awarding you fresh new RSU grants annually, so you will typically re-load new investment exposure in your employer. Establishing a strategy and maintaining discipline is therefore key to staying on course in managing your financial risk.

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Employee Stock Purchase Plans (ESPP) typically allow employees to divert 10%-20% of their paycheck over a six-month period to buy a maximum $25,000 of company shares at a 10% discount, with their share purchase price as the market price at either the *beginning or ending point* of the six months, *whichever is lower*. If held for an additional year post-purchase, these shares can be sold afterward with that original 10% discount becoming free of income tax (additional qualifying conditions exist). If you are capable of being disciplined about managing the program details it can be a good way to net yourself extra income. Participation will further increase your financial exposure to your employer though, possibly counter-productive to your diversification efforts.

MAKING SMART DECISIONS AROUND EQUITY COMPENSATION

On that note, decisions you make surrounding your employee stock compensation revolve around 1. how much company ownership exposure you already have and that amount relative to your overall net worth, 2. how long you plan to continue working at the company, and 3. a sober analysis of the company's future. Accepting stock from a growing and successful business is a great thing that can be extremely rewarding. Too much of your net worth tied to the fortunes of your employer, however? That should be avoided. Working at your company will indeed allow you certain insights as to the culture, direction, and the view from ground level or higher. But love is sometimes blind...rose tinted glasses?

We believe you deserve a strategy for your stock-based compensation. Don't expect your employer to offer much guidance, either. They often want to steer clear of any liability in giving advice. Lean on your investment and tax advisors for guidance based on our knowledge of your unique financial circumstances.

GLOSSARY:

Stock Option: The right to purchase shares of a company in the future at a predetermined price ("the strike price") per share. The higher the future market price of shares, the more valuable this option becomes, because you as the option owner can buy shares at the predetermined discounted price (profit to you).

Exercise: The act of purchasing shares at the predetermined price stipulated by your stock options when first granted. You must exercise options before they are programmed to expire.

Vesting: The transfer of ownership to you of previously granted shares. Options or RSUs are initially granted to you from your employer, but you do not gain full control/ownership until they vest on a timeline. The chief purpose of a vesting schedule is to incentivize you to remain on the job. If you were you to quit your job before the shares vest, typically your unvested stock compensation becomes worthless. There could be exceptions to this, including retirement or untimely death, both of which accelerate vesting to present day.

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