Andrew 0:04

Hello and welcome to the JGUA Financial Commentary podcast. I'm your host, Andrew Baron, and in this episode, I talked to Jason Nickerson to discuss equity compensation and a little background and considerations for those that are paid this way. But before we begin a short disclaimer, the contents of this podcast are strictly for informational purposes only, and nothing said should be taken as investment, tax, or legal advice. Any strategies discussed may not be suitable for the listeners specifically, and JGUA encourages consulting with your advisor before implementing any strategies to ensure they meet your individual objectives. And with that, welcome to the podcast, Jason.

Jason 0:51

Well, thanks for having me, Andrew. I'm excited to be here.

Andrew 0:55

Equity compensation is a little different because not everyone is exposed to this. So I'd like to give a little bit of background before we kind of get into it.

Jason 1:05

Sure. Absolutely. Equity compensation is much more common today at all levels of organizations versus 10, 15, 20, 30 years ago. Historically, it was really reserved for top level executives, not just as a piece of compensation, but also as an incentive and not just an incentive in terms of you do a good job and you get like a bonus, but an incentive to stay with the company and work hard and impact the bottom line of the company, right? Because stock price is impacted by financial results, top level execs that that companies want to retain were granted different types of equity compensation, and it was a way to draw a straight line through their hard work right to the bottom line of the company. And the reward was an increased stock price and therefore the value of the incentive compensation went up. As we've come through the decade, this has really changed substantially where equity comp is being reached down into lower levels of the organization, right down into middle management and even down further through the hierarchy, which has been nice to see. Frankly, employees at all levels of the organization can benefit from strong financial results and tie them directly to the value of equity. You can probably draw a line to Silicon Valley, frankly, or just startups in general, right, that were going public. It was a way to lure, you know, big time execs away from big time companies, and while those startups couldn't really pay cash compensation right away because because they have to retain cash to invest in other employees and other things, they could give away ownership of the company. And therefore, when it went public, big payday. The landscape of equity compensation in terms of intent, in terms of who is getting it has really drastically changed.

Jason 3:00

Now types really have not. So types of equity compensation have pretty much stayed the same over a long period of time. And we've seen this go, come and go in waves. You know, historically speaking, it is much, much more distributed to much more of the organization.

Andrew 3:13

Well, I'll just kind of let you continue on into it. What are the different types of equity comp?

Jason 3:19

Yeah. So you're looking really at two main types of equity compensation. But then there are subsets. You have stock options and there are two types of stock options non-qualified stock options and incentive stock options and we'll come back to the differentiation. Then you have restricted stock units. And then even below that, you have employee stock purchase plans and really not even equity compensation, but you're also seeing cash grants, which is kind of being blended in with equity comp. So let's go back.

Jason 3:50

Stock options really have been this long term what's been used in the longest term utilization is then incentive stock options. These come with some very favorable tax treatments if they're handled correctly. And we're not going to be able to hit every detail so I'm just providing top level overview, but if you get an incentive stock option, you want to be very, very careful because you could exercise or sell and create yourself a disqualifying event, therefore eliminating some of the tax benefit with an incentive stock option. To give you a little more background incentive stock options, there's a limitation on how much in value can be granted to any one employee in any one year. If anyone's wondering 'how come I got some incentive stock options and some non-qualified stock options?' There's probably a reason behind that because there is a limitation on how many incentive stock options in terms of value you can get real

Jason 4:44

Real quick in summary, though, incentive stock options when you exercise those and if you just exercise and hold the shares, you are not looking at any taxable compensation from that. Versus non-qualified stock options the moment at which you exercise that stock option, whether you hold or sell, you have a taxable event. Stock options in general when you're granted stock options, no tax. But then, depending on type incentive stock option when exercised, no tax, if you held the shares and non-qualified, you are taxed. In the tax treatment as a little bit different. Non-qualified stock options are taxed at ordinary rates, your marginal tax rate and with incentive stock options, it really just depends on what you do next. So if you hold the shares resulting from an incentive stock option for more than twelve months, you'll pay long term capital gains tax on the gain. If you hold it less, this is what's called a disqualifying event means you don't get that favorable long term tax treatment, and you're going to pay your ordinary marginal rate on the gain on those. There's a few more details when it comes to that holding periods. We talked about the twelve months, but there is even another one when it comes to a couple of these programs, like stock options and even employee stock purchase plans, where you have to hold the option two years from the date of grant even. And that's something that people generally don't know.

But it's been eliminated by how companies treat the stock option grants in terms of the vesting period, right? So you might get a grant today, but you may have a couple of different vesting programs. One might be a three year cliff. Something might be like a five year graduated vesting or something like that. So companies have, by their vesting periods, have really benefitted employees from really worrying about I'd have to hold the stock option for at least two years.

Jason 6:38

And that's quite broad brush. If you find yourself with a question in that arena, you really need to consult a tax advisor because there are more details below that. That's one of the primary types that people are seeing. There used to be another tax issue when it comes to incentive stock options and how they impact the alternative minimum tax. But tax law changes over the last few years have really eliminated the AMT for most people, doesn't mean it's gone, so again, that's another consultation with the tax advisor on what's going to happen if I have incentive stock options, and make sure you treat them right because you can really save a bunch of taxes if you handle those correctly.

Jason 7:10

Now compare that compare the stock option to the restricted stock. A stock option is a grant with the right to purchase shares at a standard price and when it comes to employer granted options versus market traded options like calls and puts, these have a very long expiration, usually ten years. So that's the right to buy the stock at a stated price for a decade, which is really nice because you could sit on it for eight or nine years and really watch the value grow and not incur any tax implications, or you can exercise it as soon as soon as its vested to you. Restricted stock are really a grant of shares, and you're just sitting and waiting for them to vest to you. You have to do really nothing else. Now again, it's similar to stock options that there's no taxable event when you grant or when you receive a grant of restricted shares, but when they vest to you, you're going to get a chunk of shares and that's the taxable event. It's the value of those shares on the date of vesting. And companies handle these things different ways, but most of them will withhold shares to cover tax withholdings when those vast or even on the exercise of options sometimes a withhold some shares non-qualified stock options to cover the withholding tax. But again, another disclaimer companies typically have a structured rate at which they're going to withhold federal and state, if applicable, and FICA and Medicare, the FICA and Medicare, is taken care of, but you really need to consult a tax advisor because the withholding rate may not be enough for you. And all of a sudden you end up with one or two events when you file your return, a large balance due that you weren't understanding of that that was going to happen or penalties because you didn't pay taxes in a timely fashion. Those are really the main types. Like I mentioned before, there's a couple of additional types. One is considered equity compensation and that employee stock purchase plan, the other we won't dive much into is cash grants, and that works similar to restricted stock grants and that it's just a vesting of cash and it's just sort of like a bonus.

Jason 9:10

Employer's stock purchase plans. This is one, as I said, the landscape has changed in terms of what has been happening over the years. What is being granted or what's being offered versus

not. An employee stock purchase plans are ones that have kind of gone out of favor. It can be for a number of reasons, but usually it's just administration costs. And there are some other things that coming out of the turn of the century and scandals with Enron and things like that. So over allocation of one stock and companies are really trying to be more cognizant and trying to help their employees not become over allocated to the company stock. And we call that the Enron effect. But with the ESPP, employee stock purchase plans, this really is the allowance that an employee can purchase stock at a discounted price, usually through payroll deductions and the discount the way they work can happen at different ways. It might be, you know, you get the opportunity to purchase stock every quarter with a 15% discount off of the price at the beginning of the quarter or something like that.

Jason 10:12

Interestingly enough, I had mentioned earlier about the incentive stock option holding period than the two year holding period that many people aren't aware of. Employee stock purchase plans work similarly. There is a two year holding period from the date of the option to purchase the shares at the discounted rate and comparing that to the twelve year holding period. Do you get long term capital gains tax? I'm doing the quick, broad brush that consulting with a tax advisor certainly is in the cards if you have these and are unfamiliar with tax treatment.

Andrew 10:44

So clearly, stock options are the more complicated of these vehicles. There's kind of the part of being created it and then there's the exercise part, and there's a few different ways to exercise some options. Do you want to go through those different ways?

Jason 10:59

Most people approach their stock options just like a savings account, if you will, right? Except with a few extra logistics involved of exercising and selling shares. That is typical that people in that situation are using cashless, exercise strategies. And that's really just, you know, working with the broker or the administrator of the option program and telling them, you want to exercise and sell your grant. So what they do is they literally sell the shares. So if you have 1000 shares granted to you with a strike price or an exercise price of $10, and today the share price is $20, they'll go out and they'll sell your thousand shares for 20 bucks a share. So you have $20,000, but you're not going to collect $20,000. You're going to collect substantially less than that in this example, because they're going to take $10 a share times 1000, which is your exercise price. So right off the top $20,000 becomes $10,000 and then you have the withholding taxes. And depending on what those rates are, and if you fully paid Social Security and then you add on the Medicare, your $10,000 of cash is now down to maybe $7000 or something. So that's cashless. That's a basic, simple, easy thing to do.

Jason 12:12

However, there are two other main types of exercises. One just being cash. You can really transfer wire, write a check and exercise shares to hold them. Why would you do this? Well, versus the cashless, most people in that strategy are waiting for that particular price that they

want to sell at, and then they're willing to incur the tax ramifications because again, that's done based on exercise. Let's say you are waiting, waiting, waiting and you're bumping up against your expiration period, but you still have high hopes for the stock. Take our prior example of 1000 shares at ten bucks a share exercise price, but now maybe the stock's trading at twelve. And while that's still a nice 20% gain, maybe you feel that there's good things on the horizon for the company and you know, it's probably going to be going to $20. So in that case, people would exercise at the $10 and write the check or wire the money for $10,000, and then they'll be sitting there with 1000 shares. But again, what do we have to deal with right at the time of exercise? You have to deal with withholding taxes and FICA and Medicare. So this is one of those scenarios where most brokers or administrators will say, well, the exercise is $10,000, yes, but your taxes are another $3,000, so either we're a $13,000 or wire us 10,000, and we'll withhold shares from the 1000 shares. And so you may end up with 700 shares or something like that in total. Now when you do that again, like I said, that is a taxable event, but you can hold the shares then from that point and sell whenever the price hits the price you would like to sell them. And let's say it does go to $20 after 18 months. While you've held them now for a year and you can you can pay the tax on the gain from that point all the way to the, you know, from $12 exercise point the price it was at out to 20, you pay long term capital gains on that. So it's important to understand that there's a lot of details here in how the taxes are calculated. Your cost basis is calculated of doing quick, broad brush as to how this works, but you can do that with cash.

Jason 14:16

The other interesting strategy, let's say tight on cash and you do have investments, but you don't want to liquidate them and you do already own some company stock. You can actually use a strategy called a stock swap, and this is where you trade in shares that you already own of the company, stocks gotta be the same company and exercised your shares. So your shares that you already own have value. Okay, let's go back to our scenario. Let's say you own 500 shares of stock and the stock prices $20, you can turn in your 500 shares to exercise your 1000 share grant with a strike price of $10. Those are of equal value and you still got to cover the withholding taxes and whatnot, but that's just a basic example. And what you'll end up with is you'll end up with 1000 shares, so you're giving 500 back and collecting 1000. So it's just another way of exercise and some companies you to provide some additional benefit for doing a stock swap like what they call a reload option, but that's for another podcast on an equity compensation, and not many companies do that anymore. Those are the primary exercise strategy. Again, cashless. Usually people are just doing cashless because of the price point they're looking to sell. And there's no need to exercise early if they have a good sense that the price will hit where they want it to be within that ten year grant period

Andrew 15:34

This is a great example of a reason to work with an advisor, deciding when it makes sense to choose these different options for you specifically, depending on where you are or the company you work at and your feelings for the future, et cetera.

Jason 15:51

Absolutely. When we look at it from being advisors to many busy executives who are in these types of programs, I've talked a lot about taxation already and that is more complicated than I'm covering in this discussion, certainly. But the other thing you have to look at is asset allocation, right? This is investment. These are shares of stock, and that needs to be a consideration. Now some people look at it and say, OK, how much do I own of my company stock? And that is a little bit short sighted, right? Because you also have to look at total exposure to the company in general. Remember your salary is based on that company, you have equity compensation. So there's two forms of compensation. You might have pension, you might live in a community that this company has a strong economic support of and therefore maybe housing prices and quality of schools. And so you really kind of have to step back and take it beyond just the equity compensation standpoint. And when we're looking at asset allocation, obviously, we have to be a little more lenient, right? So the rule of thumb is don't own any more than 5% in any one stock or else you start to develop single stock risk in your portfolio. We have to obviously be more lenient than that, even if we are just looking at the equity compensation compared to the rest of the investable asset. Because executives get into situations that these are being granted every year, the price may not cooperate where they want it to be. The other thing that some higher level executives have to deal with are blackout periods where they're not allowed to trade or transact in the stock, so you can see where the exposure can really pile up faster than you can liquidate it. So asset allocation does have to play a role, certainly in addition to taxation.

Andrew 17:33

I just like to add for those growth focused firms that maybe are using these equity compensation in lieu of salary. We're recording this at the beginning of November 2021, Zillow just laid off 25% of their work staff, so there is a risk of forfeiture that needs to remain present, especially when you were mentioning vesting periods earlier. I've seen sometimes people see the total value and decide that that's part of their portfolio now. But even if you very much plan to stay with the company, maybe things change and the company decides to part with you or spinoff happens or life gets in the way of even the best plan. So it's important to really evaluate what you really have versus what you might have in the future.

Jason 18:19

Great point, Andrew, because you mentioned a couple of companies. I mentioned one earlier with Enron and again, in the Enron situation, not everybody had equity compensation necessarily in the terms that we're talking about it, but some, if not all, had exposure in their 401K, whether they were able to purchase it or they're being matched in company stock. So when you talk about looking at the whole picture and the risks that lie within, this adds certainly a layer of compensation and benefits, but it needs a whole amount of risk needs to be considered. Every place you might have the equity and what else is included in that risk picture.

Andrew 18:57

So there's a couple different definitions to make stock options more favorable. It's going to sound little technical, but it's called an 83B option. Do you want to walk us through some of the mechanics of that?

Jason 19:08

Yeah, absolutely. There are two carve outs in the tax code. One is 83b and the other is 10b 51. And I know it sounds like a maybe a droid character from Star Wars that we're talking about, but we're really not. The 83b election is for those receiving restricted grants. We're not talking stock options, we're talking restricted stock grants. Primarily, this is used actually more in the private equity space than in the publicly traded space. The reason is because it's an election to tax your grants at the time of grant versus waiting for the delayed tax impact for when they vest. And why is this more used in private equity, especially firms that are thinking an IPO at some point in the future? You file that election now, you have a very short time period to file this election opposed Grant, and there's a form that needs to be completed and it needs to be sent to IRS. So this is not something that you can just decide at the time of filing your tax return that, yeah, I got restricted shares last year, I think I'll do an 83b election, no, you have 30 days and it is official forms being sent to various authorities. But that is the election to tax your grant at the time of the grant versus waiting, and in the world of private equity, think about the potential value of shares at the time of grant could be little to zero value right at the time of grant, especially the startup, but with high hopes, you file that election and let's assume for a moment that the value of those shares is zero. Well, then you pay zero tax, right? You've made the election. I want to tax my grants today, but the value of the shares are zero.

Jason 20:42

Now, let's say it's a company like Airbnb that is trading at 200 bucks a share and you have paid no tax. Then what happens is upon sale, there can be additional long term capital gains taxation upon that. So again, this is another area where you want to be working with a tax advisor on how to file it and exactly how that taxation is going to work. The other number and letter codes the 10b 51, this is a pre agreed upon sales agreement. So where does this come into play? Well, I had mentioned earlier about higher level executives and management that are subject to blackout periods. What does that mean? Well, there are periods during the year where information may be out to the management team that is not yet public. It could be for acquisitions or divestitures, or it could just be quarterly earnings where they are not allowed to trade or transact. Now I say trade or transact because they cannot buy, sell, gift, transfer of the shares. So that means charitable giving through appreciate a stock that can be done during these blackout periods. So if you think about that, if it even if it's just around earning periods, that's four times a year where there is a significant blackout period. With a company that's maybe growing or participating in a lot of M&A, there could be far more blackout periods, and the 10b 51 allows an executive to construct a sales plan based on date, price, number of shares, and these are very strict that says I'm going to sell X number of shares on certain date is very formulaic. So it is announcing in advance what is going to happen, and again, those go on file with the SEC and with the broker and so on, and those need to be strictly adhered to, but it allows you to get around the blackout

periods and it can include, you know, whether if you hold shares already or you're going to exercise and sell stock options or whatnot, so it does work for all of those equity types that we were talking about or equity comp types, but it allows that predetermination so that you can avoid being shut out for a period of time, it allows you to continue to trade along a schedule.

Andrew 22:59

Did you have any last words for our audience, Jason?

Jason 23:03

If you have received these types of benefits, congratulations, they can provide a great deal of benefit to you. But I would make sure that you are understanding or working with an advisor to understand the tax impact and exactly how to utilize these and maximize the benefits because there can be surprises or there can be benefits that you may be giving up and you just don't know it.

Andrew 23:28

This was one of our more complicated podcasts, because I know that there's a lot of it was technical, and if anyone in our audience is unsure about how some of these choices impact them or their situation, please email your questions to info@JGUA.com or reach out to us through social media or on our website. And thank you to all of our listeners. Until next time, everyone stay smart.