

# Maximizing Company Stock Compensation

Receiving shares of stock in the company you work for as part of your compensation is an excellent way to share in the success of the business, and can be very lucrative. But stock awards can be tricky to manage.

Understanding how they work and the tax implications are often key to maximizing their value.

If you're receiving equity compensation – or are considering taking a position where stock might be a part of your compensation – here are a few key questions to keep in mind:

## WHAT TYPE OF AWARD IS IT?

The two primary types of stock awards provided by employers are Restricted Stock Units (RSUs) and Stock Options. While many employers use just one of these, it's not uncommon to find employers that award stock in both forms. RSUs are essentially a promise by the company to give you a certain number of shares of stock on a specified date in the future (often called the vesting date). In

most cases, all you have to do to receive those shares is remain employed as of the vesting date. Prior to that date, you have no rights to the stock but, once the shares "vest," they are typically free to hold, sell or gift as you please.

With a Stock Option, the employer is giving you an opportunity to purchase stock in the future, up to a predetermined expiration date. However, the purchase or "exercise" price of that stock is determined up front and is usually equal to the stock's value on the date the option is granted. When you eventually exercise the option, you pay just the exercise price, regardless of the stock's actual value that day.

Stock Options offer more flexibility in that you can choose when to exercise them. However, if the stock price falls below the exercise price, the options can expire worthless. RSUs, on the other hand, only provide value if you reach the vesting date. Unless the stock price falls to \$0, you know you'll receive something of value on that date. ►

## Maximizing Company Stock Compensation *continued*

### HOW ARE THESE AWARDS TAXED?

With both RSUs and options, there is no tax cost to you at the time the award is granted. Tax consequences only come into play after the RSUs vest or the options are exercised.

With an RSU, the total value of the stock on the vesting date is considered taxable income. This is true whether you choose to hold the stock beyond that date or immediately sell some or all of the shares. This income is reported on your W-2, just like any other income the employer may provide. It's important to note the income from an RSU is considered "ordinary" income, not a capital gain.

With stock options, the tax rules are more complicated. There are two different types of stock option awards – Incentive Stock Options (ISOs) and Nonqualified Stock Options (NSOs) – and the tax rules for the two are very different.

When you exercise an NSO, the difference between the exercise price and the stock's value on the exercise date (known as the "spread") is taxable income. Like the RSU, this is the case regardless of whether you keep or sell any of the shares. Also like an RSU, this income is reported on your W-2, and is ordinary income rather than a capital gain.

When you exercise an ISO, the tax treatment at exercise is based on whether you hold or sell the stock you just acquired. If the shares are sold within a certain timeframe (typically within a year of exercise), the difference between your exercise price and the stock value on the exercise date is taxable income, just like an NSO. However, if you hold the shares (again, typically for at least a year), you can avoid including that spread on your W-2 and it will only be considered income for Alternative Minimum Tax (AMT) purposes. Depending on your tax situation, this might mean there is no tax due at all upon exercise.

### *What Happens if I Sell the Stock?*

With RSUs and NSOs, the tax treatment is very similar. Your cost basis in the shares will be the stock's value on the vesting date (for RSUs) or exercise date (for NSOs). Your holding period starts that day, and any future appreciation will be taxed as either a short- or long-term capital gain

based on how long the stock was held. If shares from an ISO exercise are held, the cost basis equals the exercise price, and like with the other shares, any appreciation beyond that is taxed as a capital gain. There may also be future AMT issues to consider, so it's important to keep good records with ISOs.

### WHAT IS THE BEST STRATEGY FOR DEALING WITH STOCK AWARDS?

Whether RSUs or options, it's important to consider them as investment decisions as well as tax decisions. How the stock fits into your overall portfolio is just as important as managing the tax cost. For example, with RSUs your only real decision comes down to holding or selling the stock once it vests. You can't control the timing of the vesting or the tax implications, so holding or selling may come down to diversification value.

Options, especially NSOs, are much the same. You can control the timing of the NSO exercise, so delaying can defer your tax and exercise costs while still allowing you to participate in the stock's growth. As the expiration date approaches, though, you become more sensitive to movements in the stock price.

With both RSUs and NSOs, it's fairly common to sell at least some shares to cover the exercise cost and taxes, but additional sales decisions should be based on a review of your overall investment strategy and the outlook for the stock.

ISOs bring some unique tax opportunities, so planning on when to exercise and whether to sell can be more complicated.

Developing a strategy for addressing RSUs and stock options is best done with the assistance of someone who understands both the tax and investment implications of these awards. Your Baird Financial Advisor has access to the tools and resources needed to analyze your situation and recommend a strategy to maximize their value to you.

Please reach out if you or anyone you know would benefit from discussing this topic further.