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EQUITY COMPENSATION

Companies are always looking for ways to recruit and retain the best workforce. Some companies offer employee equity compensation options as an important benefit, as they offer employees ownership in the company and the potential to participate in the company's growth and success.

Offering equity compensation ties employee wealth directly to the success of the company, aligning employees' interests with those of the company and incentivizing success. Stock options and other equity compensation can also provide employees with a potentially high-reward benefit at a low current cost to the company, which can be particularly valuable for startup and pre-IPO companies.

But equity compensation can be confusing and result in concentrated risk for employees unless they are able to build an investment and tax strategy around their options. Here, we outline the different types of equity compensation, how they work, and how investors can leverage these benefits over the long term.

Equity Compensation Types – The Big Three

RESTRICTED STOCK UNITS (RSU)

A restricted stock plan is a stock grant a company gives to employees that includes restrictions or applies limitations. For example, a common restriction requires employees to forfeit the shares if they terminate employment within a certain number of years. Stock grants of RSUs are often transferred at no cost to the employee, but given as a gift or bonus.

Once the stock is vested, ownership of the stock transfers fully to the employee (with no restrictions), and the employee will recognize ordinary taxable income equal to the stock's value at the time of vesting. Employers may withhold some tax for RSUs, but employees should be prepared for the tax burden when RSUs vest.

NON-QUALIFIED STOCK OPTIONS (NSO)

A stock option is the right to purchase shares of the company at a set purchase price, the "strike" price or "exercise" price. Employees can use their options to buy company stock any time up to the option's expiration, which is typically a long period of time. You are in control of when you exercise your options and when — and whether — you choose to sell any stock purchase. The more that company shares increase in price relative to your strike price, the more valuable your options become. (See the next page for an illustration.)

The exercise of stock options generates additional taxable income, as it will be taxed as ordinary income and may even put the holder into a higher tax bracket. There are some strategies that can help mitigate the tax impact, such as spreading out the exercise of stock options or coordinating them with other deferred compensation options; we recommend working with a financial and tax planner to look at your personal situation.

INCENTIVE STOCK OPTIONS (ISO)

Also called statutory or qualified stock options, ISOs are generally only awarded to executive-level employees. They are similar to non-qualified stock options in that they give the employee the right to buy stock at a strike price, but they generally require both a vesting and holding period. ISOs come with preferential tax treatment, in which profits are taxed as capital gains rather than ordinary income.

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How do stock options work?

STOCK OPTIONS VALUE = **# OF OPTIONS** x ($ **CURRENT STOCK PRICE** - $ **EXERCISE PRICE**)

Understanding your stock option choices

Stock options present employees with a number of important decisions, from when to exercise options to how to manage the resulting tax impact. It's also critical to take into consideration your overall investment portfolio and avoid concentration risk from being overconcentrated in company stock.

Strategies for diversifying your portfolio and mitigating taxes can be very complex, but we urge employees not to let that paralyze them from taking advantage of valuable stock option benefits. Speaking with a trusted advisor in advance of making stock option decisions can empower you to make educated choices and reduce your risks.

Coldstream can help.

Equity compensation can be confusing, but when used appropriately it can be a tremendous benefit, helping you build long-term wealth and security. Our planners are in your corner; we have decades of experience and can help you explore options and find the best ways to make your stock options work for you.

Contact us to learn more about how we may be able to help. Reach out at 452.283.1600 or info@coldstream.com. We look forward to learning more about the legacy you want to create.