Growing Your Practice
With Equity Compensation and
Executive Trading Plans

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Schwab Private Client Investment Advisory, Inc. (SPCIA)
Today’s Focus: Equity Compensation & Tax Planning

1. Identify equity benefit types

2. Review planning techniques

3. How to get started
What We Hear:

I have no idea what type of options I have

I don’t have to pay for the option, do I?

It’s all capital gains

I have no plan

I just exercise at expiration

All of my options are Incentive Options

I Always exercise and hold
Stock Options

- 70% of plan participants do not create or have a plan to manage their equity compensation awards. (1)
- 21% of plan participants perceive options having virtually no value (1)
- 60% of plan participants do not place significant value of equity awards (1)

(1) Source: UBS Participant Voice Survey, October 2014
Equity Compensation Summary
Stock Options

**Non-qualified Stock Options (NSOs)**
- Grant date
- Exercise or grant price
- Vesting schedule
- Expiration term (generally 10 years)

**Common Features**
- Taxation at Exercise

**Incentive Stock Options (ISOs)**
- No ordinary income at exercise
- Spread is AMT Preference Item
- Upon sale ordinary income or capital gains

Spread taxed as W-2 income
### Taxes

#### ISOs vs. NSOs

<table>
<thead>
<tr>
<th></th>
<th>ISOs*</th>
<th>NSOs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At grant</strong></td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>At exercise</strong></td>
<td>None*</td>
<td>Spread at exercise is W-2 income</td>
</tr>
<tr>
<td><strong>At sale</strong></td>
<td>Short or long term capital gain</td>
<td>Short or long term capital gain above cost basis</td>
</tr>
</tbody>
</table>

* AMT preference created when ISOs are exercised
Tax Treatment of NSOs

Upon Exercise
- Exercise Price
- Taxable Spread

Upon Future Sale
- Cost Basis
- Capital Gain
Nonqualified Stock Options (NSOs)

**NSO Considerations**

**Exercise & Sell**
- Exercise NSOs with a large taxable spread to maximize gains
- Ladder strategy using price targets
  - Manage the options/leverage
- Cashless option exercise
- Review and understand tax consequences compared to economic gain

**Exercise & Hold**
- Not generally recommended
  - Expensive
  - Continue to build concentration
- Sell-to-cover
- Hold Net shares
- Concentration concerns
Tax Treatment of ISOs

Upon Exercise
- Exercise Price
- Taxable Spread
- AMT Preference

Upon Future Sale
- Cost Basis
- Long Term Capital Gain
- AMT Long Term Capital Gain
Incentive Stock Options (ISOs)

ISO Considerations

Exercise & Hold
- Exercise early in the year, Jan.- Apr.
- Exercise when the stock price is lower to minimize AMT preference generated
- Annually exercise only up to your AMT threshold
  - Or exercise large number in one year
- Sell to cover strategy
- Use the proceeds from NSO exercises to fund ISO exercises
- Pay attention to ISO holding period
- Concentration

Exercise & Sell – Disqualifying Disposition
- Selling ISO shares prior to two years from grant and one year from exercise
- Shares are taxed at marginal income tax rate No withholding done upon sale
- Creates ordinary income May help to back out of AMT or lower exposure
- Exercise using the same strategies as NSOs
Tax Planning Issues

**Exercise**
- Don’t let your unexercised options snowball
- Exercise early in the year to allow time for tax planning
- Avoid exercising in year of expiration

**Tax**
- Focus on tax efficiency
- Be aware of tax code changes
  - $250,000 AGI and $450,000 AGI
  - $200,000 AGI and $413,200 taxable income (S)
- Consider maximizing your 401k
- Consider NQDC
- Work closely with a tax advisor
Paying for the exercise

- Cash
- Cashless
- Cashless Sell-to-Cover
- Stock Swaps
Stock Price and Exercise Strategies

High stock price
- Cashless
- Cashless sell to cover
- Swap

Low stock price or pull back in stock price
- Cash exercise
- Exercise ISOs

Anticipated rising stock price
- Sales ladder

Anticipated falling stock price – Exercise if possible
- Stop loss or stop limit order
Special Considerations

- Highly concentrated position
- Retirement planning and accelerated expiration
- Mergers and acquisitions
  - $100,000 ISO limit
- Company considerations
  - Stock holding requirements
  - 144 filings/Form 4 filings
- 10b5-1 plans
## Stock Options vs. Restricted Stock

<table>
<thead>
<tr>
<th>Stock Options</th>
<th>Restricted Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>• More option shares granted</td>
<td>• Fewer shares granted 1:3-1:4 ratio</td>
</tr>
<tr>
<td>• Option to purchase shares at vest</td>
<td>• Full value of share at vest</td>
</tr>
<tr>
<td>• Option may be underwater</td>
<td>• Share price may depreciate or appreciate</td>
</tr>
<tr>
<td></td>
<td>• Provides direct, measureable value</td>
</tr>
<tr>
<td></td>
<td>• Encourages employee share ownership</td>
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</tbody>
</table>
Restricted Stock Grants

- Issued as shares or units
- No taxes due at grant
- Vesting Schedule

Upon Grant

- Settled in shares of company stock
- Taxes owed on the value of the shares at vest
- Company usually withholds shares to cover tax liability
- W-2 Income
- 25% Withholding

Upon Vest

Possible Forfeiture of Shares Upon Separation
83(b) Election RSAs Only

83(b) election = pre-payment of tax
Pay tax on FMV within 30 days of grant
Shares subject to forfeiture risk
Irrevocable election

Other 83(b) issues
- Early exercise stock options
- Restricted stock units – not eligible
83(b) Election Considerations

May make sense when...
- Good expectation of growth
- The stock price is low
- Likelihood of forfeiture is small

May not make sense when...
- Price decline
- High stock price
- Risk of forfeiture
Trading Windows

Period of time when employees may or may not trade in company stock – buy or sell

Closed window
- No trades in company stock allowed
- Has access to material, non-public information
- Can be called at any time
- Can be pushed down to other employees

Open window
- Trades in the company stock allowed
- No competitive advantage to marketplace

10b5-1 Trading Programs
10b5-1 Plans

Agreement or contract
- Created during open trading window

Document creating the plan
- Plan effective date
- Plan termination date
- Disclosure statements

Sales instructions
- Specify amount, price, and date
- Include written formula
- Delegate discretion, with no subsequent influence
Considerations for 10b5-1 Plans

Keep plan instructions simple
- Easy to monitor
- Easy to make calculations
- Easy to understand intention

Ensure prior coordination with corporate counsel
- Internal policies/politics
- Corporate trading policy

Do not alter or deviate from the plan
- Or exert influence

Other rules remain in effect
- Rule 144 sales volume restrictions
- Rule 144 filing requirements
- Short swing profit rules
Other Special Considerations

- Non-Qualified Deferred Compensation (NQDC)
- Charitable Giving of Equity Compensation
- Pre-IPO Planning
- Stock Swaps
- Employee Stock Purchase Plan (ESPP)
- Section 16 insider Considerations
- Net Unrealized Appreciation (NUA)
Non-Qualified Deferred Compensation (NQDC)

Contract to defer compensation (governed by IRC 409A)

- FICA and FUTA still apply

100% of your compensation may be deferred

- Subject to company rules

NQDC plans are typically un-funded

- Subject to forfeiture, creditors

Key considerations:

- Have I maxed out my contributions to traditional plans?
- Can I afford to defer compensation?
- Will my tax rate potentially be lower at retirement?
- How flexible is the distribution schedule?
- What investment choices does the plan offer?
- Is my company financially secure?
- How concentrated am I in the company stock and within deferred accounts?
Charitable Giving of Equity Compensation

Generally, charitable deductions can be made up to 50% of AGI

- 30% limitation applied to private foundations, veterans organizations, fraternal societies

Short term capital gains cannot be deducted as part of the gift

- Cost basis of asset is used in short term assets

Non-Qualified Stock Options (NQ) might be charitably gifted, but...

- Company must allow this gift
- W2 created is still attributed to the employee

Incentive Stock Options (ISO) gifts are not allowed

Employee Stock Purchase Plan (ESPP) shares may be gifted

- Once held for two years of the subscription date
- Donation should occur from a brokerage account, not the stock plan account
Pre-IPO Planning

Prepositioning of equity awards for IPO or other liquidity event
- Enhanced tax efficiency – Capital gains vs. Ordinary Income or AMT
- 83(b) election

Risk management
- Illiquid assets, not publicly traded
- Concentration
- Taxes

Other Financial Considerations
- Appropriate investment
- Paying for the exercise
- Paying for the tax
- Lock up periods
Stock Swaps

Method for exercising options- Using company stock in lieu of cash

Assume this scenario:

- 100 Option
- Grant Price = $10.00
- Stock Price = $50.00
- 75 Shares Already Held with a Basis of $35.00

ISO Example

- Exercise Cost: $100 \times $10.00 = $1,000
- Shares to swap: $1,000/$50.00 per share = 20 Shares
- Two Cost Lots: 20 shares with $35.00 cost basis
  80 shares with $0.00 cost basis
- Holding period for all 100 new shares starts over.
Employee Stock Purchase Plan (ESPP)

**Purchase shares of employer stock at a discount**

- Enrollment period
- Share purchases and look back (if applicable)
- Elect a percentage of pay - cap on number of shares purchased ($25,000 limit)
- Purchase at a discount

**Taxes and other considerations**

- Discount is always taxed as ordinary income
- Disqualifying sale: A sale that occurs before holding the shares for two years from offering period and one year from purchase date
- Value between discounted purchase price and FMV on purchase date is ordinary income
- Pay attention to losses at sale
- Qualifying sale: shares held for more than 2 years from the offering date and held for at least 1 year and 1 day from purchase date
- Only taxed when you sell shares
- Concentration
Section 16 Insider Considerations

Insiders and affiliates
- Directors, officers, principal stockholders (>10%)

Form 3 and 4 filing requirements
- Filed with the SEC when there has been a beneficial change in ownership

Rule 144 and volume limitations
- 1% of outstanding shares of the same class during any 3 month period
- Or, if publically traded, the greater of 1% or the average reported weekly trading volume during the preceding 4 weeks.

Short swing profit rules
- Profit from a transaction (purchase and sale) with respect to company stock during a given 6 month period
- Restricted Stock vesting counts as purchase
- Profit must be returned to the company or shareholders

Other considerations
- Trading windows
- 10b5-1 trading plans
- Company trading policy
Net Unrealized Appreciation (NUA)

What is NUA?

- The FMV (fair market value) of company stock in a qualified plan – The cost basis of the stock = **NUA**

How does NUA work?

- Transfer company stock in kind from qualified plan to a taxable account at retirement; other qualified assets can be rolled into an IRA
- Cost basis of stock is taxed as ordinary income; 10% early distribution penalty applies under age 55
- NUA is taxed at long term capital gain rates at sale of stock irrespective of holding period
- Additional appreciation is taxed as short or long term gain depending on holding period

Who can benefit?

- Retiring Employee over age 55 with low basis stock

What are the Other Financial Considerations?

- Liquidity – Ability to pay taxes on the cost basis
- Concentrated Equity Position – Percentage of portfolio invested in company stock
- Full Distribution Required – Entire balance of qualified plan must be distributed within single calendar year
- Balance Taxable and Tax Deferred Assets in Retirement – NUA strategy may reduce future RMDs from qualified accounts
- Cost Basis Calculation – Cost lot vs. average basis? If per lot, could choose low cost shares for NUA strategy
Important information

Equity Compensation is a very complicated topic, and planning raises complex tax, legal, estate planning, and investment management issues. This presentation is intended to give you general information about your equity compensation and is designed to help you understand the value of your company stock and options. All stock prices and tax calculations are hypothetical and are used for demonstration purposes only.

We recommend you review your employee options regularly - at least once a year - as your financial situation, and market conditions, change over time. We also recommend you integrate this information into your overall financial plan, which should consider, estate, retirement, risk management and tax issues.

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