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Your Gen Y Planning Guide to Employee Stock Options

If you work for a startup or publicly traded company, part of your compensation package may include company stock. Maybe it was mentioned in your offer letter, or perhaps you received stock options as a bonus or as part of your total comp plan. Either way, congratulations! This can be an incredible opportunity to build wealth.

But company stock can be incredibly confusing. What's the difference between ISOs, NSOs, RSUs, and ESPPs? What does it mean to "exercise" your options? When will you owe taxes?

At Gen Y Planning, we help clients navigate these exact questions all the time. We've seen people make smart decisions that accelerate their financial goals, and we've also seen people leave thousands of dollars on the table simply because they didn't understand how their company stock works.

This guide will walk you through the four main types of employee stock compensation:

1. Incentive Stock Options (ISOs)
2. Non-Qualified Stock Options (NSOs)
3. Restricted Stock Units (RSUs)
4. Employee Stock Purchase Plans (ESPPs)

By the end, you'll understand each type, how they're taxed, and most importantly, when to consider selling shares.

Let's dive in!



Understanding Stock Options: The Basics

Before we get into the specifics, let's clarify some common terms you'll encounter:

- **Grant:** When your company gives you stock options or units. This is just a promise, you don't actually own anything yet.
- **Vesting:** The process of earning your shares over time. Most companies require you to stay at the company for a certain period before you can access your shares. For example, a typical vesting schedule for ISOs is four years with a one-year cliff (meaning 25% vest after year one, then the remaining 75% vest monthly over the next three years).
- **Exercise:** The act of purchasing your shares at the predetermined price (called the strike price or exercise price).
- **Strike Price/Exercise Price:** The price you'll pay per share when you exercise your options.
- **Market Value:** What the stock is currently worth on the open market.
- **Bargain Element/Compensation Element:** The difference between the exercise price and the current market value. This is essentially your "discount."

Now, let's explore each type of stock compensation.

Incentive Stock Options (ISOs)

What Are ISOs?

ISOs are typically granted to employees at startups (not publicly traded companies) as a way to attract, retain, and reward talent. If you're working at a startup and received company stock, they're most likely ISOs.

When you receive ISOs, you get a grant with a specified price per share. Once your options vest, you can choose to exercise them at that price. If the fair market value (FMV) has increased, you're essentially buying company stock at a discount. But there's a caveat: for companies that aren't publicly traded (not on a stock exchange) there has to be a liquidity event (i.e. merger, Initial Public Offering (IPO), or tender offer) in order for you to be able to sell your shares.

Remember: the shares aren't worth anything until they vest, and they often vest over three to four years. The longer you stay at the company, the more shares you'll have vested.

How Are ISOs Taxed?

This is where ISOs shine. They offer two major tax benefits:

- 1. No tax when you exercise:** Unlike other stock options, you don't owe taxes when you buy your shares.*
- 2. Lower tax rate when you sell:** If you sell your shares at least one year after exercising AND two years after they were granted, you'll pay the much lower long-term capital gains tax rate (0%, 15%, or 20% depending on your income) instead of ordinary income tax rates (which can be as high as 37%). This is called a "qualifying disposition" and it's the holy grail of ISO taxation.

*Note that you may be subject to Alternative Minimum Tax, or AMT. It's essentially an additional way to calculate the taxes you'll owe. You end up paying whichever tax rate is higher. Read on for more information about AMT.

The AMT Catch

Even if you meet all the requirements for long-term capital gains, you could be subject to AMT in the year you exercise the options. If you're making six figures, this is definitely a possibility.

That bargain element (the difference between exercise price and market value at exercise) gets added back to your AMT calculation. In the example above, this is the difference between \$2.50 and \$10 per share or \$7,500 for the 1,000 shares exercised. This likely wouldn't trigger AMT, but what if you had exercised 10,000 or 100,000 shares? Then you'd likely have a large tax bill on your hands. You'll owe the higher of your regular tax liability or your AMT liability. This is why it's crucial to talk to a tax professional before exercising large amounts of ISOs.

Risks to Consider

- You often must exercise within 90 days of leaving your company, potentially forcing you into a taxable event even if you're not ready. However, some grants may be able to be exercised for up to 10 years after you receive them, even if you leave the company. Be sure to read the details!
- If you hold shares to get the lower tax rate, you risk the stock price declining during that holding period. Or worse, the company never has a qualifying event, so your shares aren't worth anything ever!
- If your company folds after you've exercised, your shares become worthless, and you've lost the money you spent exercising. However, you can take your investment as a loss on your tax return.
- You can't sell until your company goes public, is acquired, or has a qualifying event, so these shares have zero liquidity or real value until then.



Non-Qualified Stock Options (NSOs)

How NSOs Are Like ISOs

NSOs work very similarly to ISOs. You receive a grant with a specified price per share, and you can exercise once they've vested. The goal is the same: buy company stock at yesterday's price even though it's worth more today.

The vesting schedule is typically identical to ISOs (three to four years, often with a one-year cliff).

The Tax Difference

Unfortunately, NSOs lack the favorable tax treatment of ISOs. Here's the big difference:

With NSOs, you owe ordinary income tax as soon as you exercise your options.

The compensation element (the difference between exercise cost and current market value) is taxed as ordinary income and reported on your W-2. This means you'll pay not just income tax, but also Social Security and Medicare taxes on this amount.

The silver lining? NSOs aren't subject to the dreaded Alternative Minimum Tax.

Real Life Example

You have 1,000 stock options with an exercise price of \$20 per share (cost to exercise: \$2,000). The current stock price is \$40 per share (current market value: \$4,000).

The \$2,000 compensation element (\$4,000 market value minus \$2,000 exercise cost) is immediately taxed as ordinary income when you exercise. If you're in the 24% tax bracket, you'll owe about \$480 in federal income tax right away, plus state taxes and payroll taxes.

Later, if you sell the shares, you'll pay capital gains tax on any additional appreciation (long-term rates if you held for more than a year, short-term if less).



Cashless Exercise

Because NSOs are taxed immediately at exercise, many people opt for a "cashless exercise." This means you exercise your options and immediately sell them, using the shares themselves to pay for the exercise cost.

This approach:

- Eliminates the need to come up with thousands of dollars to exercise
- Locks in your gain immediately
- Frees up money for other financial goals

When You Have Multiple Stock Types

Sometimes companies grant various types of stock (ISOs, NSOs, and RSUs) to the same person. This often happens when a startup goes public or gets acquired. Managing the tax implications of multiple stock types can be complex, which is why we strongly recommend working with both a financial planner and a tax professional.

Restricted Stock Units (RSUs)

What Are RSUs?

RSUs are a bit different from stock options. Instead of giving you the option to buy shares at a set price, your company grants you a certain number of shares that you'll actually receive once they vest.

You don't pay anything to receive RSUs. Once they vest, the company distributes the actual shares to you (or more accurately, distributes most of the shares after withholding some for taxes).

RSUs are common at publicly traded companies. They're often granted when you're first hired or later as a bonus.

How Are RSUs Taxed?

When your RSUs vest, the shares are considered ordinary income. Your company will automatically withhold a portion of the shares to cover income taxes. You'll see this on your W-2. Like bonuses, RSUs have federal tax withheld at a flat 22% unless you elect to have more withheld. If you are in a higher tax bracket, you should consider electing a higher withholding amount so that you don't receive a surprise tax bill come April.

After you receive your shares, if you hold them for at least 12 months before selling, any additional gain will be taxed at the long-term capital gains rate. If you sell within 12 months, the gain is taxed as ordinary income.

Real Life Example

You're granted 4,000 shares with a four-year vesting period (1,000 shares per year):

Year 1: 1,000 shares vest when stock price is \$20 (\$20,000 taxed as ordinary income, taxes are withheld)

Year 2: 1,000 shares vest at \$25 (\$25,000 taxed as ordinary income, taxes are withheld)

Year 3: 1,000 shares vest at \$30 (\$30,000 taxed as ordinary income, taxes are withheld)

Year 4: 1,000 shares vest at \$35 (\$35,000 taxed as ordinary income, taxes are withheld)

Total: \$110,000 was taxed as ordinary income across the four years.

If you hold all the remaining shares and sell them 14 months after the final vesting date for \$50 per share (\$200,000 total), the \$90,000 gain is taxed at long-term capital gains rates.

The "What If You Got a Bonus?" Test

Financial planners often recommend selling RSUs as soon as they vest. Why? Because you've already paid ordinary income tax on them.

Think about it this way: If you received a \$20,000 bonus, would you immediately use it to buy your company's stock? If the answer is no, then you should probably sell your RSUs and use that money for other financial priorities.

How RSUs Compare to Options

Unlike ISOs and NSOs, RSUs don't have a strike price. This means they'll hold value as long as the company's stock has any value at all. Even if the stock price doesn't grow, your RSUs are still worth something.

However, options (especially ISOs) have an advantage: it's possible to pay taxes on the entire gain at the lower capital gains rate, whereas RSUs are always taxed as ordinary income at vesting.



Employee Stock Purchase Plans (ESPPs)

What Are ESPPs?

ESPPs allow you to purchase shares of your company stock at a discounted price, typically 5-15% off. Your company makes participation easy through payroll deductions.

During offering periods (usually twice a year), you decide what percentage of your paycheck to contribute, up to \$25,000 per year. Contributions are made with after-tax dollars.

How ESPPs Work

Over a defined period (usually 3-6 months), you contribute through payroll deductions. This period begins with the offering date and ends with the purchase date.

On the purchase date, the company uses your accumulated funds to buy shares on behalf of all participating employees.

The Lookback Provision

Many ESPPs include a powerful feature called a lookback provision. This allows you to purchase stock at the price from either the beginning OR end of the offering period, whichever is lower. You get the discount on top of this lower price.

This can create significant gains!

Real Life Example

You want to contribute \$10,000 through your ESPP. The share price at the beginning of the offering period (six months ago) was \$40, but the current price is \$50.

Your ESPP lookback provision lets you lock in the \$40 price. With a 10% discount, you'll pay \$36 per share and receive 277 shares instead of 200 shares at the current price. If you sold right away you'd lock in an instant 39% return (before paying taxes)!

Tax Treatment

If you hold your ESPP shares for more than one year after the purchase date AND more than two years after the beginning of the offering period, it's a "qualifying disposition." Any profit above the discount will be taxed at long-term capital gains rates.

If you sell earlier, it's a "disqualifying disposition" and the profit is taxed at ordinary income rates.

Pro tip: Most ESPP platforms will show you whether your shares qualify for long-term or short-term treatment, making it easy to choose which lots to sell.

Should You Participate in Your ESPP?

The immediate 10-15% discount is tempting, but we generally recommend maxing out your 401(k) first due to tax advantages and diversification.

That said, ESPPs can be extremely useful for other financial goals. Some of our clients max out ESPP contributions and sell immediately to lock in the gain, even though they pay ordinary income tax.

You want to be mindful of how buying company stock fits in with your other investments. The key is to avoid having too much of your net worth concentrated in a single company.

Rewards and Risks

Rewards:

- Automatic 5-15% discount
- Lookback provision to lock in more gains
- Convenient payroll deductions
- Some companies match contributions
- No tax at purchase, only when you sell

Risks:

- Concentration risk (too much invested in one company)
- Market risk (stock price could decline while you hold)
- Emotional bias (you may hold too long because you "know" the company)

Keep in mind, there are special tax benefits for shares acquired through an ESPP: if you hold the shares for 2 years after the grant date and one year after the purchase date, it is considered a qualifying disposition. This means that the discount (difference between the grant price and purchase price) is taxed as compensation and any profit above the grant date price is taxed as long term capital gains (since it's been held for at least a year).

Making Smart Decisions: A Framework

Now that you understand the four main types of stock compensation, how do you decide what actions to take with your holdings? Here's our framework:

➤ 1. Understand What You Have

Log into the account where your shares are held. Identify:

- What type(s) of stock you have (ISOs, NSOs, RSUs, ESPPs)
- How many shares or options
- The exercise/strike price (for options)
- Your vesting schedule
- Any special provisions (like lookback periods for ESPPs)

➤ 2. Consider Your Overall Financial Picture

Before making any stock decisions, ask yourself:

- Do I have an adequate emergency fund?
- Do I have high-interest debt?
- Am I maxing out my 401(k)?
- How much of my net worth is already tied to my company?

Your company stock should fit into your broader financial plan, not drive it.

➤ 3. Diversification is Your Friend

Because you already rely on this company for your paycheck and benefits, it can be risky to hold a significant percentage of your investments in the company as well. By selling shares of company stock, you can free up some of your money to reinvest elsewhere.

➤ 4. Get Tax Help Before Big Moves

Stock compensation creates complex tax situations. Before making major decisions:

- Work with a tax professional to run tax projections
- Talk to your tax professional about AMT implications for ISOs
- Plan for estimated tax payments
- Understand the interplay between different stock types

➤ 5. But Don't Let Taxes Run the Show

Yes, taxes matter. But don't hold onto a concentrated stock position solely for tax benefits. It's better to pay taxes on a gain than to watch gains evaporate while you're trying to optimize tax treatment, especially if you have higher priority financial goals (i.e. paying off high interest rate debt, rebuilding emergency savings, etc.).



When to Get Help

You should consider working with a financial planner and tax professional if:

- You've been granted any form of stock compensation
- You're considering exercising options
- You're about to leave your company and have unvested stock
- Your company is going through an IPO or acquisition
- You have multiple types of stock compensation
- You're not sure how stock fits into your overall financial plan

At Gen Y Planning, we help clients navigate these situations every day. We've seen the difference proper planning can make, sometimes adding tens of thousands of dollars to our clients' bottom lines simply through smart timing and tax planning.

Conclusion

Employee stock compensation can be an incredible wealth-building tool, but it requires thoughtful strategy. Whether you have ISOs, NSOs, RSUs, ESPPs, or a combination, understanding how they work and how they're taxed is the first step.

Remember these key principles:

1. **Diversification matters.** Don't concentrate too much wealth in your employer.
2. **Your overall financial picture comes first.** Max out retirement accounts and build emergency savings before optimizing stock strategies.
3. **Tax planning is crucial.** Work with professionals to avoid costly mistakes.
4. **When in doubt, lock in gains.** It's better to pay taxes on a profit than to watch profits disappear.
5. **Use your money to match your values.** Ultimately, we want to help you use your money to live an amazing life!

If you'd like help navigating your company stock situation, [we're here to help](#). Let's work together to turn your stock compensation from a theoretical company benefit into real wealth.

