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What advisors need to know about equity compensation plans

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Equity compensation awards have become available to more employees in the past couple years. How can advisors help their clients get the most out of them?

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An asset that's often misunderstood
While equity awards are a big component of compensation for pre-IPO companies, they're also increasingly offered to a broader set of employees at dynamic publicly held companies. This trend can create significant opportunities for advisors to add value to a growing segment of clients — many of them younger and in need of long-term planning.

Our experience with employees receiving stock awards is that many of them don't understand the basics of this type of compensation. Even fewer understand the nuances. And that's understandable since award programs can vary significantly from one company to another — and even between employees at the same company.

Advisors can add value to their clients with equity compensation in three key ways:

- Educate them on how equity compensation works, including implications for taxes and portfolio allocation.
- Help them understand the details of their specific plans and holdings.
- Develop strategies for tax optimization and risk management.

Framing the conversation: Talking to pre-IPO clients
Employees at pre-IPO companies are often undercompensated in base salary and bonuses compared with their peers at larger, public companies. This makes understanding the balance between the risks and rewards of exercising their equity awards at any given time critical to their overall planning.

It's important that equity awards are considered compensation. Company stock awards will, in most instances, count as W2 income along with base wages and bonus cash compensation. [1] As W2 income, awards are subject to income tax withholdings and payroll tax. But unlike cash compensation, they are deposited in the employee's brokerage account, not their bank account, which is one reason why this type of compensation is misunderstood.

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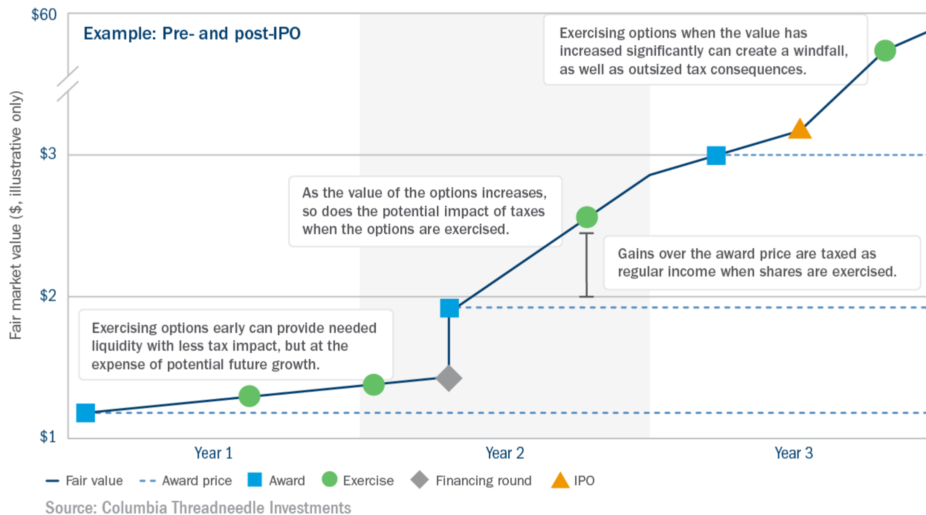
Once it's acquired, the stock can be viewed as an investment, but one that almost always comes with limitations. For example, there are usually restrictions on the transferability of the stock before an event like an initial public offering, making it difficult or impossible to liquidate. And even after the company goes public, there may be plan-imposed controls such as lockup and blackout periods, holding requirements and limits on hedging or using the stock as collateral for a loan. All these factors inform decisions on when and how much to hold or sell.

Because no two plans are alike, it's critical to become familiar with a plan's details, discuss how much liquidity a client needs, determine the short and longer term costs and risks, and help them choose the best times to access it. Clients who receive early awards at pre-IPO companies need to determine if their employer permits actions, such as early exercise, that lock in lower taxes and improve the future tax posture when the stock is sold.

Even without early provisions, clients with pre-IPO equity compensation may need to be reminded to consider acting on vested options when the tax impacts may be lower — which means keeping track of the stock price and upcoming funding rounds.

Balancing the risks and rewards of exercising equity options

Financial advisors can add value early in the timeline, not just around the IPO



Source: Columbia Threadneedle Investments

The other end of the spectrum: Equity compensation at public companies

Back in the 1980s, stock options were the most common type of equity compensation. Nowadays, restricted stock units (or time-vested awards) are more common, as well as performance stock units (time- and performance-vested awards), which incentivize employees to remain at a company and hit certain success metrics. Rather than the up-and-comers at startups, it's typically the highly skilled and executive employees who receive these awards. The higher up they are, the more likely they'll have a mix of two or three types of equity awards, making their situations more complex.

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But no matter what flavor, it’s still compensation that’s added to W2 income when the stock is acquired. For high earners, and especially executives, significant increases in income can bump them into higher tax brackets — a situation where tactical use of elective deferred compensation plans can help offset extra tax liabilities.

A common concern, particularly among clients who have amassed significant stock positions over long periods, is a lack of diversification. While they may blush at the tax bill when they exercise shares or receive shares due to vesting restricted stock grants, diversifying those shares *can* be done without adding much, if anything, to the tax bill.

The bottom line

Starting a conversation about equity compensation with your clients can deepen your current relationships and lead to new opportunities to add value and gather assets. Clients who understand what they have through their equity compensation plan are better prepared to consider how it fits into their wealth strategies and more eager to talk to someone who understands its nuances about their larger wealth management picture.

DISCLOSURES:

[1] The one exception is the exercise of an incentive stock option. The exercise does not generate W2 income or any income in the standard tax system. It does generate alternative minimum tax income (AMTI).

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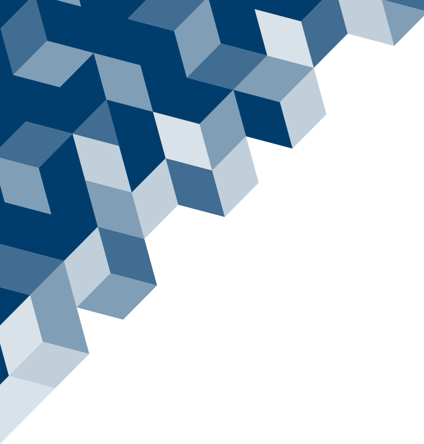

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