

Equity Compensation 102

*Advising clients with significant
company stock positions*

Overview

- **Navigating multiple forms of equity compensation**
- **Sales skills**
- **Best practices and common mistakes**

Warm-Up Quiz

Test your knowledge #1:

A client started at a tech company's inception 9 years ago and received stock that is now worth \$10,000,000. Assuming zero basis and maximum tax rates, if she sells now, roughly how much:

- **Federal tax will she pay?**
- **CA tax will she pay?**

Test your knowledge #2:

A client has NQSOs currently worth \$4,000,000 vesting over four years. She has worked at the company's SF headquarters the past three years, when the options were granted, and has just permanently moved to Nevada in anticipation of exercising the entire amount next year.

Assuming maximum tax rates, when she exercises how much:

- **Federal tax will she pay?**
- **State tax will she pay?**

Answers to #1:

A client started at a tech company's inception 9 years ago and received stock that is now worth \$10,000,000. Assuming zero basis and maximum tax rates, if she sells now, roughly how much:

- **Federal tax will she pay?**
- **-> Probably zero**
- **CA tax will she pay?**
- **-> \$1,330,000 (13.3% * \$10,000,000)**

Answers to #2:

A client has NQSOs currently worth \$4,000,000 vesting over four years. She has worked at the company's SF headquarters the past three years, when the options were granted, and has just permanently moved to Nevada in anticipation of exercising next year. Assuming maximum tax rates, when she exercises how much:

- Federal tax will she pay?
- $\rightarrow \$1,574,000 (37\% + 1.45\% + 0.9\%) * \$4,000,000$
- State tax will she pay?
- $\rightarrow \$399,000 (13.3\% * \frac{3}{4} * \$4,000,000)$

**Advising clients, and
getting them to actually
follow your advice**

Sample Client

Issues and Challenges

Equity Compensation Framework

190,000 shares, including unvested stock options

<i>Up Front Sale</i>	<i>%</i>
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-

<i>Systematic Liquidation Sleeve</i>	<i>%</i>
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-

-

<i>Long-Term Sleeve (Hold Indefinitely)</i>	<i>%</i>
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-

190,000 shares, including unvested stock options

<i>Up Front Sale</i>	<i>20%</i>
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-

<i>Systematic Liquidation Sleeve</i>	<i>60%</i>
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FIVE YEARS

-

-

<i>Long-Term Sleeve (Hold Indefinitely)</i>	<i>20%</i>
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-

***Not all shares have the same
risk/reward profile***

190,000 shares, including unvested stock options

<i>Up Front Sale</i>	<i>20%</i>
<i>LEAST POWERFUL SHARES</i>	

-

<i>Systematic Liquidation Sleeve</i>	<i>60%</i>
<i>FIVE YEARS</i>	

-
-

<i>Long-Term Sleeve (Hold Indefinitely)</i>	<i>20%</i>
<i>MOST POWERFUL SHARES</i>	

-

The power of leverage

Current Stock Price: **\$80.00**

Options (NQSOs)

Total Shares (vested plus nonvested)	Exercise Price/Share	Value at \$80	Value at \$84	% increase
25,000	\$8.00	\$1,800,000	\$1,900,000	5.6%
25,000	\$12.00	\$1,700,000	\$1,800,000	5.9%
40,000	\$20.00	\$2,400,000	\$2,560,000	6.7%
60,000	\$60.00	\$1,200,000	\$1,440,000	20.0%

190,000 shares, including unvested stock options

<i>Up Front Sale</i>	<i>20%</i>
<i>LEAST POWERFUL SHARES</i>	

-

<i>Systematic Liquidation Sleeve</i>	<i>60%</i>
<i>FIVE YEARS</i>	

-

-

<i>Long-Term Sleeve (Hold Indefinitely)</i>	<i>20%</i>
<i>MOST POWERFUL SHARES</i>	

- 38,000 NQSOs with \$60 purchase price

190,000 shares, including unvested stock options

Up Front Sale **20%**

LEAST POWERFUL SHARES

- 38,000 shares owned outright, starting with highest cost basis
 - Sell half immediately upon opening of next trading window
 - Sell half when XYZ reaches \$99.50

Systematic Liquidation Sleeve **60%**

FIVE YEARS

-
-

Long-Term Sleeve (Hold Indefinitely) **20%**

MOST POWERFUL SHARES

- 38,000 NQSOs with \$60 purchase price

190,000 shares, including unvested stock options

Up Front Sale **20%**

LEAST POWERFUL SHARES

- 38,000 shares owned outright, starting with highest cost basis
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 - Sell half when XYZ reaches \$99.50

Systematic Liquidation Sleeve **60%**

FIVE YEARS

- Sell 5,700 shares per quarter
 - Existing shares first
 - Options with least leverage next
-

Long-Term Sleeve (Hold Indefinitely) **20%**

MOST POWERFUL SHARES

- 38,000 NQSOs with \$60 purchase price

***“If it’s taxed like cash,
treat it like cash.”***

190,000 shares, including unvested stock options

<i>Up Front Sale</i>	<i>20%</i>
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LEAST POWERFUL SHARES

- 38,000 shares owned outright, starting with highest cost basis
 - Sell half immediately upon opening of next trading window
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<i>Systematic Liquidation Sleeve</i>	<i>60%</i>
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FIVE YEARS

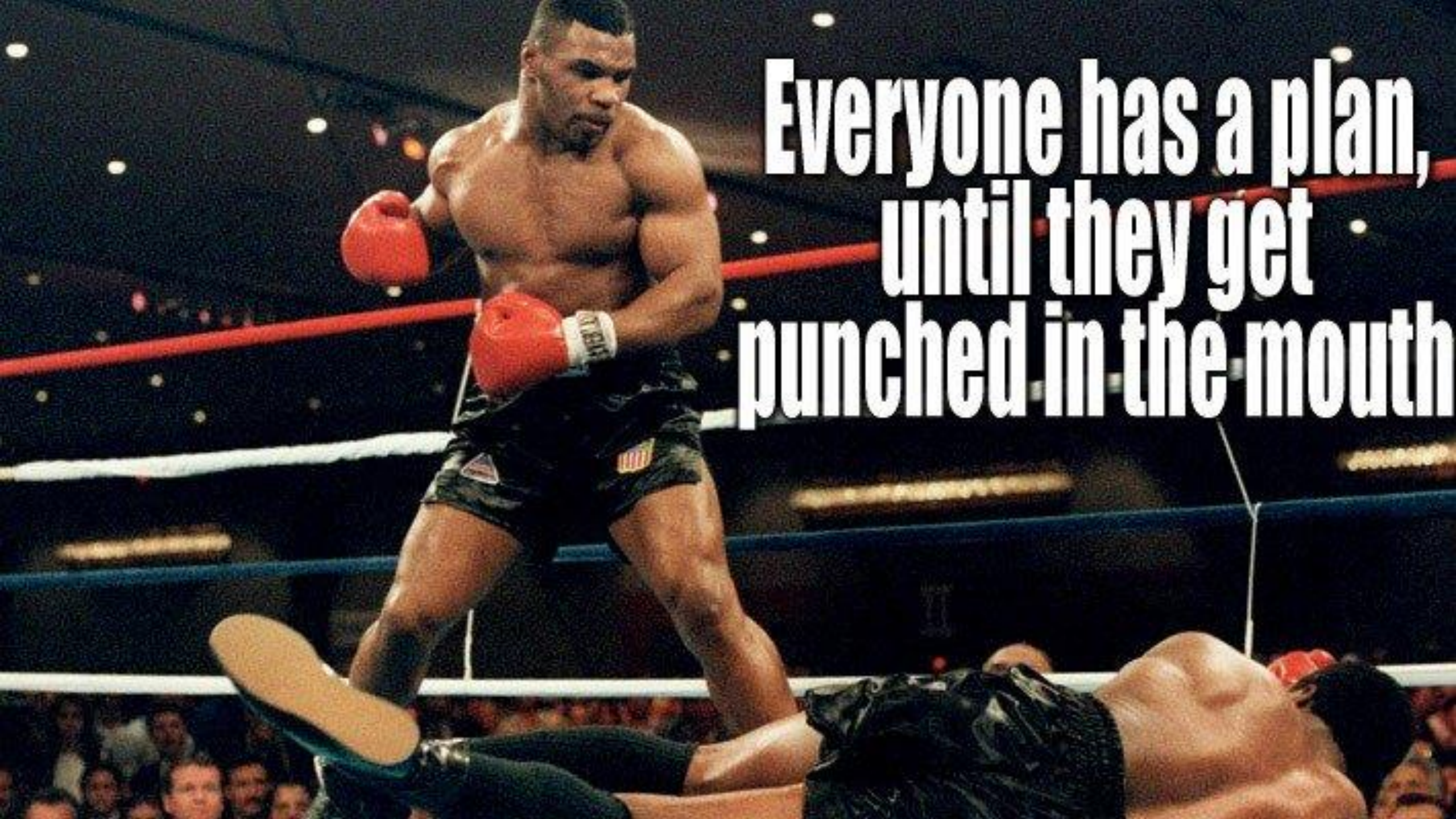
- Sell 5,700 shares per quarter
 - Existing shares first
 - Options with least leverage next
- Immediately liquidate all RSUs upon vesting

<i>Long-Term Sleeve (Hold Indefinitely)</i>	<i>20%</i>
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MOST POWERFUL SHARES

- 38,000 NQSOs with \$60 purchase price

**Everyone has a plan,
until they get
punched in the mouth**





Outcome

Questions?

Common Mistakes

Nonqualified Stock Options

- **Common mistake:**
 - **Exercising “when stock is down”**

Unexercised stock options:

the best risk/reward profile on the planet?

Compensation vs Long-term capital gains

Scenario

- 10,000 vested NQSOs that expire in 5 years
- \$50 purchase price
- \$100 current stock price
- 20% future growth rate
- Maximum tax bracket

Goal: Full liquidation at end of five years.

-> Decision: exercise now, or wait five years?

NQSOs: early exercise vs delayed cashless sale

Assumptions						
# of Shares	10000					
Stock price now	\$100					
Exercise Price	\$50					
Appreciation rate	20%					
# of Years	5					
Marginal Tax Rate	37%					
LTCG Tax Rate	20%					
Stock price at end:		\$248.83				
Option 1: exercise now and hold						
Shares received	Shares surrendered for purchase	Shares withheld for taxes	Shares remaining	value at sale	less taxes on sale	After-tax value
10,000	5,000	1,850	3,150	\$ 783,820.80	\$ (93,764.16)	\$ 690,056.64
Option 2: wait until end to exercise						
Shares exercised	Shares sold	Share price at sale	Gross value at sale	Less purchase price	Less taxes	After-tax value
10000	10000	\$ 248.83	\$ 2,488,320.00	\$ (500,000.00)	\$ (735,678.40)	\$ 1,252,641.60

Nonqualified Stock Options

- **Best practice: don't exercise until ready to liquidate**
- **"Fruit on a tree"**
- **Focus on compounding the greatest number of shares**
- **Aim is to *maximize* taxes**

$$X - Y = Z$$

assets

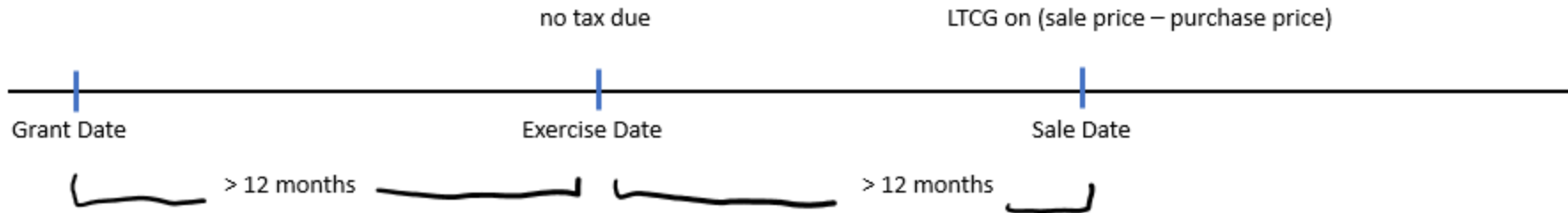
taxes

wealth

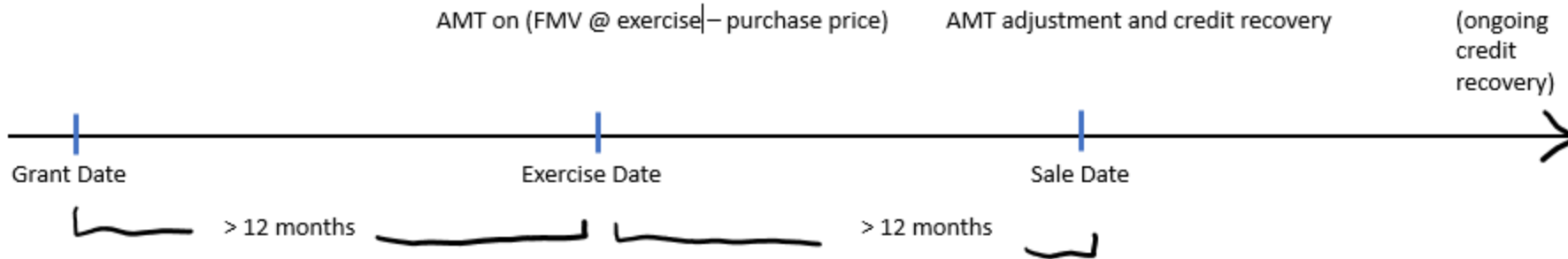
Incentive Stock Options (ISOs)

ISOs: Qualifying Disposition

Regular Tax



Alternative Minimum Tax

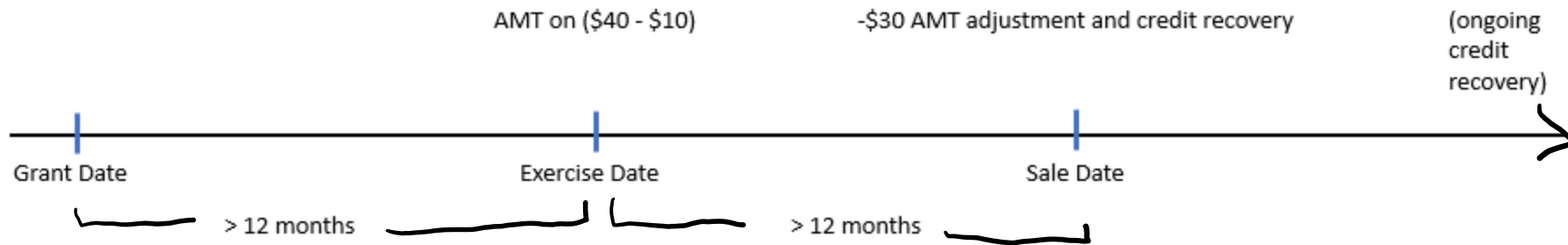


ISO taxation: example (good outcome)

Regular Tax

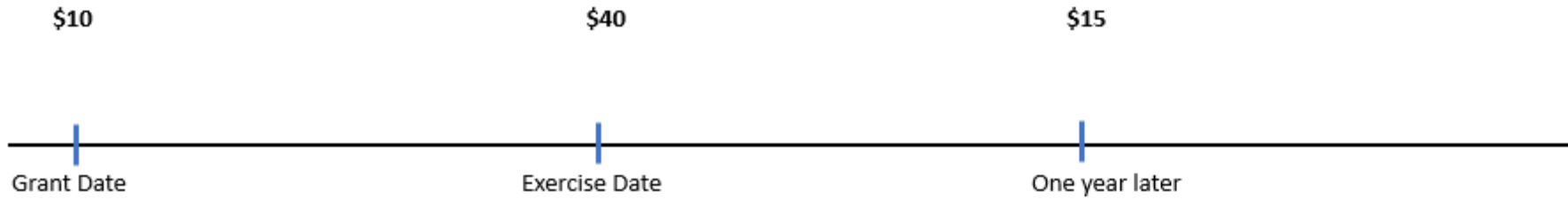


Alternative Minimum Tax

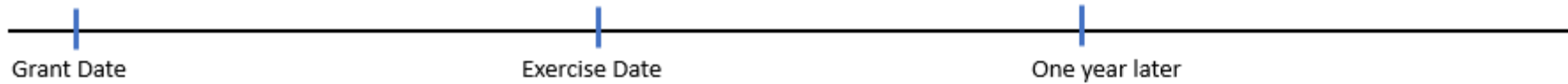


ISO taxation: example (bad outcome)

Regular Tax



Alternative Minimum Tax



Incentive Stock Options

- **Danger: exercising and holding late in year**
- **Best practice: exercise in Q1 if planning to hold the shares**
 - **LTCG treatment after 365 days**
 - **If drops, can sell before 12/31 to cancel AMT**

Incentive Stock Options

- **Tax trap: AMT “wash sale” rule**
 - **You cannot cancel AMT if you buy back the shares within 30 days**
 - **Internal Revenue Bulletin 2004-36**

**What about *really*
obstinate clients?**



Reaching the unreachable

- **Ineffective:**
 - **Sermonizing**
- **Better:**
 - **Stories**
- **The secret?**

Use *their* stories

**What most advisors (and
often their CPAs) miss**

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Qualified Small Business Stock (QSBS)

- Up to \$10,000,000 capital gain exclusion (Federal only)
- Personal rules
 - Owned shares at least five years
 - Received the shares directly from the company
 - Acquired the shares after 8/10/1993 (preferably after 9/27/2010)
- Company rules
 - Domestic C corporation
 - <\$50,000,000 in assets when shares were acquired
 - Not a “service” business

www.QSBSinfo.com

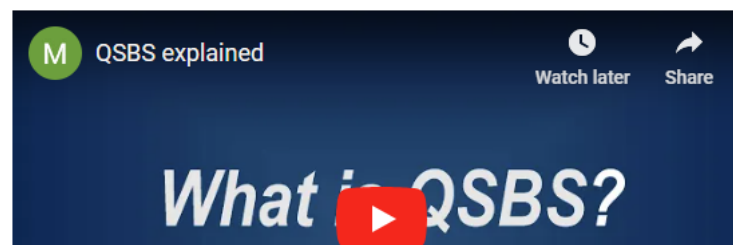


Everything there is to know about

Qualified Small Business Stock

Qualified Small Business Stock (QSBS) is an opportunity to exclude up to the entire gain of the sale of your start-up, closely-held business or company stock from federal taxes.

This comprehensive site covers all things QSBS from A to Z, from a basic introduction to the finer details, including special situations, every relevant IRS Private Letter Ruling and court case, and the full text of section 1202.



Answers to #2:

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FTB Publication 1004

Allocation rules apply to:

- **Restricted Stock**
- **Nonqualified Stock Options**
- **ISOs if disqualifying disposition**

Allocation rules do not apply to:

- **Shares owned outright**
- **ISOs held >365 days from exercise**

Coaching Program

- **Wealthy (\$5M - \$25M) clients are incredibly underserved**
 - **Asset gatherers masquerading as advisors**
- **High demand for comprehensive advice**
 - **They can't find it**
- **You are the advisor the wealthy are looking for**
 - **Need to re-orient skill set and positioning**

Questions?

Thank You

**Together we're elevating
the profession**

