

An HR leader's guide to understanding employee equity compensation

Stock options, RSUs, job offers, and taxes—
navigate the complex world of employee equity
compensation with ease



A note from Origin's lead CFP®

The benefits of employee equity compensation are many—especially if cash flow is tight at your company or you're losing out on top talent. This popular form of ownership can give companies a big leg up while recruiting and incentivizing top-performing employees.

However, if you're like most people (including your employees!), this is a subject area that you're unfamiliar with and may not feel confident discussing with your workforce.

If this is you, you're not alone. Equity compensation is an incredibly complex, challenging topic to understand. And we recognize that you don't have the bandwidth to learn every detail about stock options, RSUs, vesting schedules, and taxes.

That's why we will give you a crash course in equity compensation basics. In this guide, you'll find only the most essential information you need to navigate the equity compensation waters—explained in the simplest terms.

This knowledge will help you feel empowered going into conversations with employees and even educate the rest of your workforce to understand their compensation better.



“Employee equity compensation can be complicated, confusing, and intimidating. I've worked with hundreds of HR leaders to give them the right tools and information so they can empower their employees to make smart decisions around their equity compensation.”

Heather Comella, CFP®, Lead Financial Planner

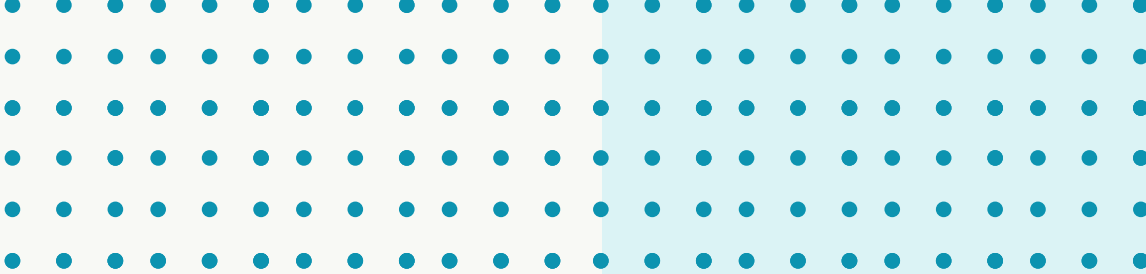


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Key terms and definitions

We asked a team of seasoned Certified Financial Planner™ professionals the most common terms and definitions HR leaders should know about equity. This is what they said.

➤ Stock Option

An offer that gives employees the right to purchase (“exercise”) shares of a company’s stocks at a predetermined price (“strike price”), subject to specific time limits and conditions.

➤ Non-Qualified Stock Options/Nonstatutory Stock Option (NSO)

A type of stock option that’s offered to both employees and non-employees. NSOs are generally not as tax-advantageous as ISOs.

➤ Incentive Stock Options/Statutory Stock Option (ISO)

A type of stock option that’s only offered to employees. ISOs come with additional qualifiers and can be more tax-advantageous compared to NSOs.

➤ Restricted Stock Unit (RSU)

Offers employees (typically at larger, public companies) a set number of shares of stock at a future date, upon the completion of a vesting schedule. Unlike options, employees don’t have to buy RSUs—they’re just given.

➤ Restricted Stock Award (RSA)

Gives early employees (typically at startups) a set number of shares of stock, at no cost on the grant date or at a discounted price.

➤ Employee Stock Purchase Plan (ESPP)

A company-run program that offers employees the ability to purchase company stock at a discounted price. To participate, employees contribute to the plan through payroll deductions and, on the purchase date, the company uses the employee’s accumulated funds to purchase stock in the company at a discount.

➤ Alternative Minimum Taxes (AMT)

A tax system that places a floor on the percentage of taxes that people must pay to the government, regardless of how many deductions they claim. Exercising ISOs can trigger AMT.

➤ Fair Market Value (FMV, for public companies)

The price that an asset is currently selling for on the open market.

➤ Fair Market Value (FMV, for private companies)

Also referred to as the 409a value, which is based on an independent appraisal of the company’s stock value. The 409a is used for tax purposes when employees exercise their options.

➤ Grant

An award of equity or options given to an employee. Some grants have waiting periods, frequently referred to as vesting periods, before the grantee can take full ownership of the award.

➤ Exercise

To purchase stock at the preset price defined in an employee's option grant, regardless of the stock's price at the time.

➤ Exercise Price/Strike Price

The set price at which a stock can be bought when it's exercised.

➤ Sale

When an employee disposes of the stock that was acquired, following the legal guidelines outlined in their grant.

➤ Spread

Refers to the difference between two comparable measures, such as the difference between the exercise price of an option and the fair market value of the equity.

➤ Vesting Period

The period of time an employee must wait to fully exercise their rights to certain assets. Vesting periods are typically applied to stock options, RSUs, retirement funds, and certain benefits.

➤ Bargain Element

The spread from strike to fair market value at exercise.




➤ 83(b) Election

A document that a stockholder can file with the IRS to elect to pay taxes on the total FMV of equity within 30 days of grant (for RSAs) or 30 days of early exercise (for early exercisable options), rather than at the time the equity vests.



The most common types of equity compensation

Employee equity compensation is non-cash compensation that gives employees an ownership stake in the company. It can be in various forms, most often in the form of restricted stock or the ability to buy company stock at set prices.

Equity award type		Vesting and exercising	Taxes
 Stock Options	Incentive Stock Options (ISOs)	<ul style="list-style-type: none"> You don't own them until you purchase them You can't purchase them until they vest Vesting is normally time-based 	<ul style="list-style-type: none"> You may have to pay taxes when exercising, unless you trigger the Alternative Minimum Tax Provide tax benefits if you hold them long enough
	Non-qualified Stock Options (NSOs)		<ul style="list-style-type: none"> Your company withholds taxes Likely be taxed at the ordinary income tax rate
 Restricted Stocks	Restricted Stock Units (RSUs)	<ul style="list-style-type: none"> You own them after they vest May vest over time or upon a liquidity event 	<ul style="list-style-type: none"> Considered income when they are delivered Some vested RSUs are withheld or sold to cover income taxes, and the rest given to you as shares
	Restricted Stock Awards (RSAs)	<ul style="list-style-type: none"> You receive a set number of shares of stock at no cost on grant date 	<ul style="list-style-type: none"> No taxes at grant, unless you file a Section 83(b) election At vesting, you owe income tax if you didn't file an 83(b)
 Employee Stock Purchase Plans		<ul style="list-style-type: none"> Employees can purchase stock at a discounted price, usually up to 15% off Use payroll deductions to purchase 	<ul style="list-style-type: none"> Pay taxes at the time you sell the stock Depending on factors, will pay ordinary income tax on partial or all gains

Stock options

Stock options are an offer that allows employees the right to purchase shares of a company's stocks at a predetermined price, subject to specific time limits and conditions.

The offer will include the:

- ✦ **Grant date:** The date a stock option is granted to the recipient
- ✦ **Grant amount:** The number of stock options
- ✦ **Exercise price:** The price an employee pays to buy the option
- ✦ **Vesting schedule:** The period of time an employee waits to vest

Example

Grant date: May 1, 2022

Grant amount: 15,000 non-qualified stock options at \$0.50

Vesting schedule: 4 years, with a one-year cliff followed by monthly vesting



There are two main types of stock options:

1. Incentive Stock Options (ISOs)
2. Non-qualified Stock Options (NSOs)

We'll go into detail of how they differ in the following pages.

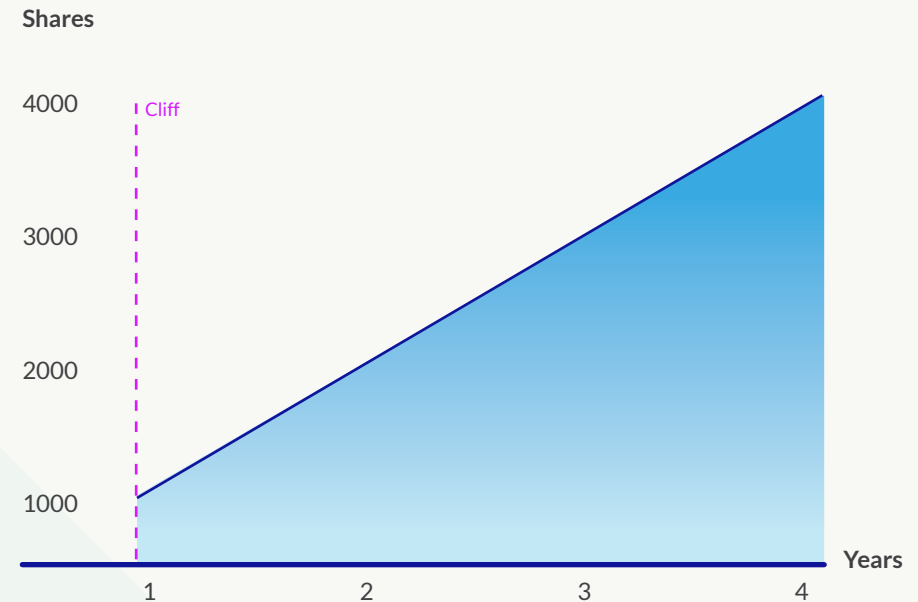
Incentive Stock Options (ISOs)

ISOs are a type of stock option that gives employees the right—within a designated timeframe—to buy a set number of their company’s shares at a predetermined price. ISOs can only be offered only to employees.

How to exercise

ISOs usually contain a vesting schedule that must be satisfied before the employee can exercise their options. Most companies use a vesting schedule that gives employees ownership of stocks over a period of time. For example, a four-year vesting schedule with a one-year cliff is very common.

With this schedule, your employee owns zero options in their first year of service. After their first year with the company, they’ll receive 25% of the options they were granted and then incrementally more every month until they reach four years.



Example of a 4-year vesting schedule with a 1-year cliff

If the employee leaves the company before the four years, they lose any unvested options. They’re also typically given 90 days from when they quit to exercise. If the employee never exercises their options, they lose all economic benefits.

Sometimes options are “early-exercisable,” which means employees can exercise before the options are vested—usually for tax benefit purposes, which will require the employee to file an 83(b) with the IRS within 30 days of early exercise. If employees leave before vesting, the company will usually purchase the unvested equity back.

Once the vesting period is completed your employees have several options for exercising their options:



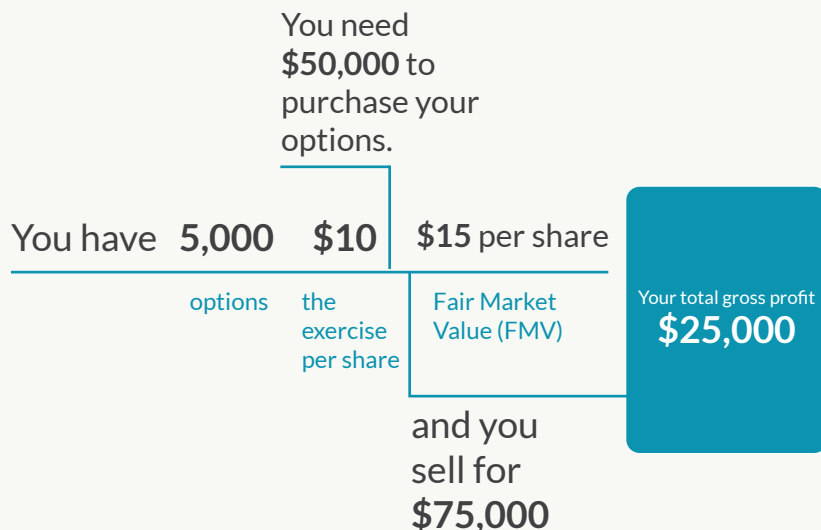
1. Exercise and hold

This is when the employee exercises their options and holds the equity in anticipation of an Initial Public Offering (IPO) or future liquidity event.

If the company is public, the employee may hold the equity for more than one year to receive better tax treatment before selling. If they hold the equity beyond December 31 following exercise, the employee may owe Alternative Minimum Taxes (AMT) when they file their taxes.

The pros and cons of exercise and hold

Example



Liz is an early employee at a fast-growing startup. She is granted 60,000 options at \$1 per share. She exercises her options when the FMV hits \$20 per share.

She is subject to AMT, and ends up owing taxes on \$1,140,000.

(\$20FMV - \$1 exercise price x 60,000 shares)

She believes her company is going to grow, and expects her shares to increase in value. She decides to hold the position for 1 year for better tax treatment.



The Good

Liz's company's valuation grew to \$35 per share after a year. It's been 2 years since Liz has been granted the stock, and 1 year since she exercised it.

She decides to sell all her options at the current FMV. Because she decided to wait 1 year before selling, she is subject to a much more favorable tax rate. Liz is taxed on \$90,000 of capital gains.

$$\begin{aligned} \$35 - \$20 &= \$15 \\ \$15 \times 60,000 &= \$90,000 \end{aligned}$$

When it's time to file her taxes, she will pay 15% in taxes, rather than 24% if she decided to sell immediately after exercising.



The Bad

Instead of her company growing, Liz's company had a major scandal, and stock prices plummeted to \$3 per share.

She is preparing her taxes, and tallying up her other income, she is taxed at a rate of 24%.

She has to include the \$1,140,000 of income for AMT.

Liz owes more than \$273,600 on taxes for shares only worth \$180,000. This doesn't take into account state taxes she may owe as well. Liz is unable to pay her taxes even if she sold her stock at its current value. This is an example of how market volatility can impact the tax liability of an individual who decides to exercise and hold in favor of better tax treatment.

2. Exercise and sell

If a company goes public and the employee still hasn't exercised their options, it may make sense to do a same-day exercise-and-sell of vested options. Unfortunately, these gains will be taxed as ordinary income. However, it's a riskless scenario and the employee will still have proceeds they can use for other purposes.

The employee could also choose to stretch the timing out and opt to exercise and sell in the same calendar year. With this option, the gains will still be taxed as ordinary income, but it'll no longer be riskless as they'll be exposed to the employer equity price fluctuations until they sell.

3. Exercise and partially sell

This is when the employee exercises their options and sells a portion of their shares—usually to use those proceeds to help exercise the rest of the equity. The part of the equity that's sold will be taxed as ordinary income, but the part that's not sold will usually receive better tax treatment if held for more than one year.

4. Stock swap

The exchange of one equity-based asset for another that typically happens during a merger or acquisition, where ownership of the target company's shares is exchanged for an equal value of shares of the acquiring company.



Tax implications

For employers

ISOs don't qualify as a deductible expense to the company.

For employees

There are no taxes at grant or during the vesting period for ISOs. How ISOs are taxed depends on how and when your employee disposes of the stock, which could be a:

1. Qualifying disposition

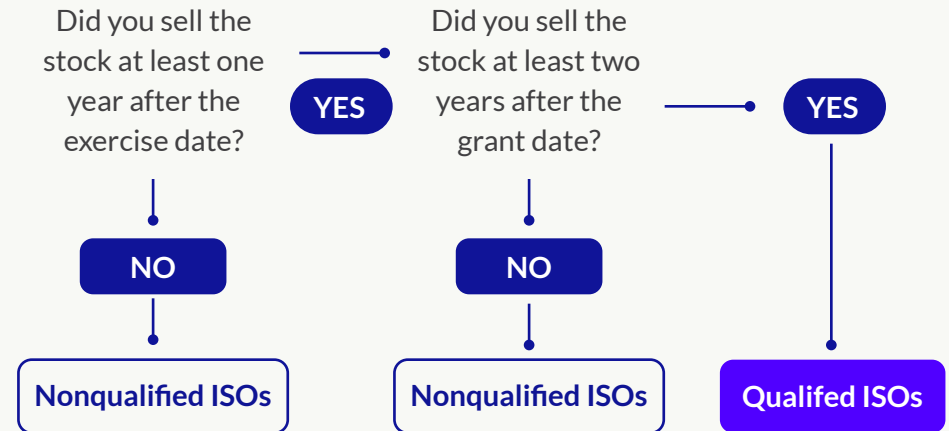
This allows people to receive capital gains treatment, which essentially means they'll be taxed at a much lower rate than ordinary income tax, on the bargain element. To qualify, the shares received from ISOs must meet two requirements:

- Be held for at least one year from the date of exercise
- Be held two years from the date of grant

2. Disqualifying disposition

Employees who make disqualifying dispositions must pay ordinary income tax rates on the bargain element of the sale, as well as capital gains tax on any profit realized from the sale of the stock. If one of the two requirements from qualifying isn't met, it will be disqualifying and receive worse tax treatment.

Qualified vs Non-Qualified Disposition



PRO TIP

An employee who exercises their ISOs may owe AMT.

To estimate how much they may owe, your employee can either complete the IRS Form 6251 or use a calculator. However, calculating AMT can be very complex, so any employee granted ISOs should consult with a qualified financial professional as well.

Also, if the strike price is equal to the FMV when you exercise (or early exercise), AMT will be \$0.

Non-qualified Stock Options (NSOs)

NSOs are a type of stock option that gives employees the right—within a designated timeframe—to buy a set number of their company’s shares at a predetermined price. NSOs can be offered to both employees and non-employees.

NSOs typically receive worse tax treatment than ISOs, which may lead you to wonder why companies give them out. The answer is that they’re usually forced to since only \$100,000 (by strike price) of ISOs can vest each year for an employee, which means that anything extra must be an NSO.

How to exercise

NSOs, like ISOs, usually contain a vesting schedule that must be satisfied before the employee can exercise their options. As we mentioned in the previous section, most companies use a vesting schedule that gives employees ownership of stocks over a period of time—such as a four-year vesting schedule with a one-year cliff.

Once the vesting period is over, your employees have the same options for exercising their NSOs as they do their ISOs.



Tax implications

For employers

NSOs qualify as a deductible expense to the company.

For employees

NSOs aren’t as tax-advantageous as ISOs. However, this makes the taxation process much more straightforward. Like ISOs, there are no taxes at grant or during the vesting period for NSOs.

When an employee exercises an NSO, the spread between the exercise price and the stock’s 409a value (the “bargain element”) is generally taxable as ordinary income. When the shares are sold, employees can expect to pay capital gain taxes on everything above the bargain element.

In summary

ISOs

- Only offered to employees
- Typically follows a vesting schedule
- Don't qualify as a deductible expense for the employer
- No taxes at grant or vesting
- No income taxes payable at exercise but may potentially owe AMT at the end of the year when the employee does their taxes
- With qualifying disposition, receive capital gains treatment on everything above the strike price

NSOs

- Offered to both employees and non-employees
- Typically follows a vesting schedule
- Do qualify as a deductible expense for the employer
- No taxes at grant or vesting
- Ordinary income tax due on the bargain element immediately at exercise
- When selling, receive capital gains treatment on everything above the bargain element (the FMV at exercise)

PRO TIP



If the exercise price is equal to the 409a FMV (bargain element = \$0), your employees can exercise their NSOs and lock in \$0 of tax on the bargain element.

Restricted stocks

Sometimes, companies offer restricted stocks instead of stock options. These types of stock are not transferable until certain conditions are met. Restricted stock is used a form of employee compensation in which they become transferable after certain conditions are met, such as a vesting period.

The two most common types of restricted stocks are:

1. **Restricted Stock Units (RSUs)**
2. **Restricted Stock Awards (RSAs)**

Restricted Stock Units (RSUs)

RSUs offer employees a set number of shares of stock at a future date, upon the completion of a vesting schedule. RSUs are typically granted at larger, public companies. However, if they're offered at private companies, RSUs will typically be subject to a "double-trigger" to fully vest (time + liquidity event).

How to acquire

RSUs, like NSOs and ISOs, also usually contain a vesting schedule that must be satisfied before the employee has a legal right to their shares.

While it's most common for employees to receive RSUs when the company is already publicly traded, RSUs can technically be granted pre-initial public offering (IPO) as well. If this occurs, there may be what's called a "double-trigger" that applies to the vesting requirement. In this case, the employee must satisfy the vesting requirement for the RSUs, and there must be a liquidity event for the shares to fully vest.

The liquidity event could be:

- The company going public
- An acquisition or merger
- The company being sold in a private equity market

It's also important to note that, unlike stock options, RSUs don't have an exercise price. This means that employees with RSUs, upon vesting, will automatically receive normal shares of company stock without having to pay anything to acquire the shares.

Tax implications

For employers

RSUs qualify as a deductible expense to the company. Keep in mind that many companies withhold federal income taxes on RSUs when the employee's shares vest—not at the regular W-4 tax rate—but at the lower supplemental income tax rate of around 22% for an amount less than \$1 million and a rate of 37% for an amount over \$1 million, as well as FICA, and state taxes.

For employees

There are no taxes at grant for RSUs. The entire amount of vested stock is counted as ordinary income in the year it vests and will appear in your employee's W2 along with their compensation income—even if the employee doesn't sell it.

To calculate your employee's taxable income, take the FMV of the stock at the time of vesting and multiply it by the number of shares that vested. Also, keep in mind that income from RSUs is subject to applicable state and local taxes.

Once RSUs are vested and taxed, they become normal shares. As a result, if an employee decides to sell their RSUs later, any gains above the original vested amount will be subject to capital gains taxes.

Action

- You receive an RSU grant
- Your RSUs vest
- Your RSUs vest and you sell at that time
- You sell shares within 1 year of vesting
- You wait more than 1 year after vesting before selling your shares

Tax implication

- No tax implication
- You'll pay ordinary income tax on the value of the shares
- If the price you sell at is higher than the FMV of when you vested, you'll pay short-term capital gains tax
- If the price you sell at is higher than the FMV of when you vested, you'll pay long-term capital gains tax

PRO TIP



It may be helpful to think of RSUs as a cash bonus. It's just instantly invested in the company's stock and is taxed the same way. Also, keep in mind that the supplemental withholding rates that employers follow are typically not enough to cover the actual tax owed. Employees should consult a financial professional to see if they need to make estimated quarterly tax payments to avoid an underpayment penalty from the IRS.

Restricted Stock Awards (RSAs)

RSAs give employees a set number of shares of stock, at no cost on the grant date or at a discounted price. RSAs are typically granted to early employees at startups.

How to acquire

Since employees legally own their RSA shares when they're granted, vesting only impacts whether the company can repurchase their shares if they leave or are terminated. However, most companies still choose to have a vesting schedule and hold RSA shares in escrow until the requirements are met. Employees can't sell their RSA shares during this time.

Tax implications

For employers

RSAs qualify as a deductible expense to the company.

For employees

There are no taxes at grant for RSAs, unless the employee chooses to file a Section 83(b) election. This allows them to report the FMV of shares at the time of grant, rather than the FMV once the RSAs vest.

At vesting, if the employee didn't file an 83(b) election, they owe income tax on gains from the purchase price to the vested 409a FMV. When they sell the shares,

they're subject to capital gains tax on any additional gains between the FMV at vesting and the sale price.

In summary

RSUs

- Typically offered by large, public companies
- Typically follows a vesting schedule but are subject to a "double-trigger" if offered by a private company, which requires time and a liquidity event
- Qualify as a deductible expense to the employer, who also usually withholds supplemental income taxes at a flat rate
- No taxes at grant
- Can't file for 83(b) election
- Taxed as ordinary income at vesting and is subject to capital gains taxes after selling

RSAs

- Typically offered by early-stage startups
- Typically follows a vesting schedule and holds the employee's RSA shares in escrow until the requirements are met
- Qualify as a deductible expense to the employer
- No taxes at grant or purchase of RSAs
- Can choose to file for 83(b) election
- Ordinary income taxes at vesting on the difference from purchase to vesting 409a FMV, unless the employee filed for 83(b) election at purchase

PRO TIP



We recommend filing for an 83(b) election at purchase. This can be beneficial because there might be zero income tax if you purchased the shares for the current FMV. Or the tax might be really small if you purchased them at a discount or received them for free.

Employee Stock Purchase Plan (ESPP)

ESPPs are a company-run program that offers employees the ability to purchase company stock at a discounted price—usually up to 15% off. To participate, employees contribute to the plan through payroll deductions and, on the purchase date, the company uses the employee's accumulated funds to purchase stock in the company at a discount.

How to participate

In this section, we're assuming that your organization offers a qualified ESPP, which is the most common type and simply means the program adheres to IRS guidelines.

Qualified ESPPs prohibit any person who owns more than 5% of the stock in the company from participating in the plan. They can also disallow certain categories of employees from plan participation, such as anyone who has worked for the company for less than one year.

ESPPs generally go through four phases:

Grant: The employer grants its employees the option to purchase stock in the company at a discounted price relative to the FMV.

Offering period: The time during which employees accumulate savings for the future purchase of the company's stock, which can be done by having a percentage or fixed dollar amount deducted from their paychecks on an after-tax basis.

Transfer: At the end of the offering period, the employer takes all the saved money and uses it to purchase shares of the company's stock on the employee's behalf.

Disposition: After the shares are transferred into the employee's name, they're free to sell, trade, exchange, transfer, or give them away.

Tax implications

For employers

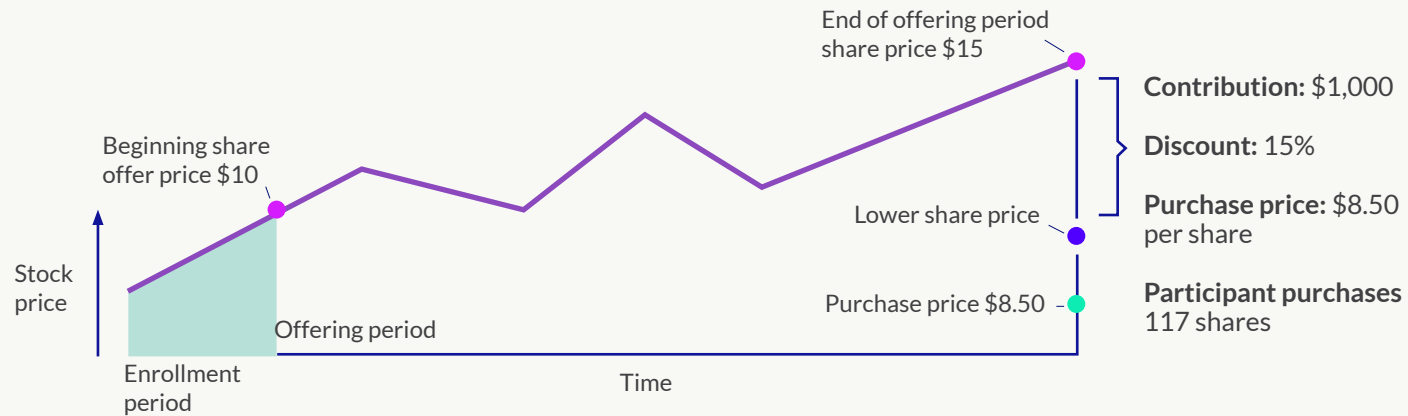
ESPPs qualify as a deductible expense to the company.

For employees

The specific tax impact of disposing of ESPP stock is governed by four factors:

- The length of time the stock is held
- The price the stock is actually purchased at, factoring in the discount
- The price of the stock on the offering date
- The price of the stock on the purchase date

Typically, different tax treatments for qualifying dispositions vs. disqualifying dispositions.



Example of an ESPP with a \$1,000 contribution with a 15% discount on the purchase

Qualifying dispositions

Participants who meet the holding requirements for qualifying dispositions will pay ordinary income tax on the discount and capital gains on any increase in share price above that. A qualifying disposition is any sale or transfer of ownership of the ESPP shares after the person has held the stock for both:

- More than one year after the date of transfer
- More than two years after the date of offer

Disqualifying dispositions

Participants who don't meet the holding requirements for qualifying dispositions will pay ordinary income tax on all gains. Non-qualifying dispositions are sales of ESPP shares that occur either:

- Before and up to one year after the transfer date or before
- Up to two years after the date of offer

Pros

- Can be logistically easier for the employee since deductions are automatically made and the employer purchase shares on their behalf
- Great for employees to lock in a 15% benefit

Cons

- Can lead to a lack of diversification
- Can be risky if a large part of an employee's investments are in one company, especially since many will try to hold onto the stock for at least one to two years to get a qualifying disposition before selling

PRO TIP



Diversification can suffer from regular contributions to an ESPP—especially if you also issue RSU grants to your employees as part of compensation. So your employees should consider selling their shares as soon as they purchase them and meet with a financial planner to develop a strategy for doing this in the most tax-efficient way.

Helping your employees understand their equity compensation

Now that you're armed with all the information you need, it's time to put your learnings into action.

Here are a few things you can do to help your employees better understand their equity compensation:

Provide guidance during salary negotiations

During salary negotiations, many employees blindly accept equity as part of their compensation without understanding their value. This isn't beneficial to your new hires, as they likely won't know how to maximize their equity or, worse, may get hit with a surprise tax bill down the line.

Instead, your team should use this checkpoint as an opportunity to educate your employees about the equity you're offering. Take the time to explain the vesting schedule, exercising options, and tax implications—and give them the chance to ask questions.

This will help your employees make informed decisions and understand the true value of their equity, rather than just accepting what's being handed to them.

Create a library of resources

While every employee's financial situation will be slightly different, there are general questions the majority of your workforce will have regarding the topic of equity. It may be helpful to create a library of resources to educate employees on the basics of equity compensation and address their common concerns proactively.

This library can include things like:

- A one-pager that covers frequently asked questions
- A glossary sheet with equity-related terminology
- Recorded video sessions with a financial or legal expert
- A list of more in-depth resources employees can access

Hire a specialist

If you find yourself overwhelmed by handling employee questions about stock options, consider hiring an equity compensation or stock compensation specialist. This team member can help you manage employee questions and serve as the "expert" in the HR department, freeing up more resources for you while still supporting your employees.

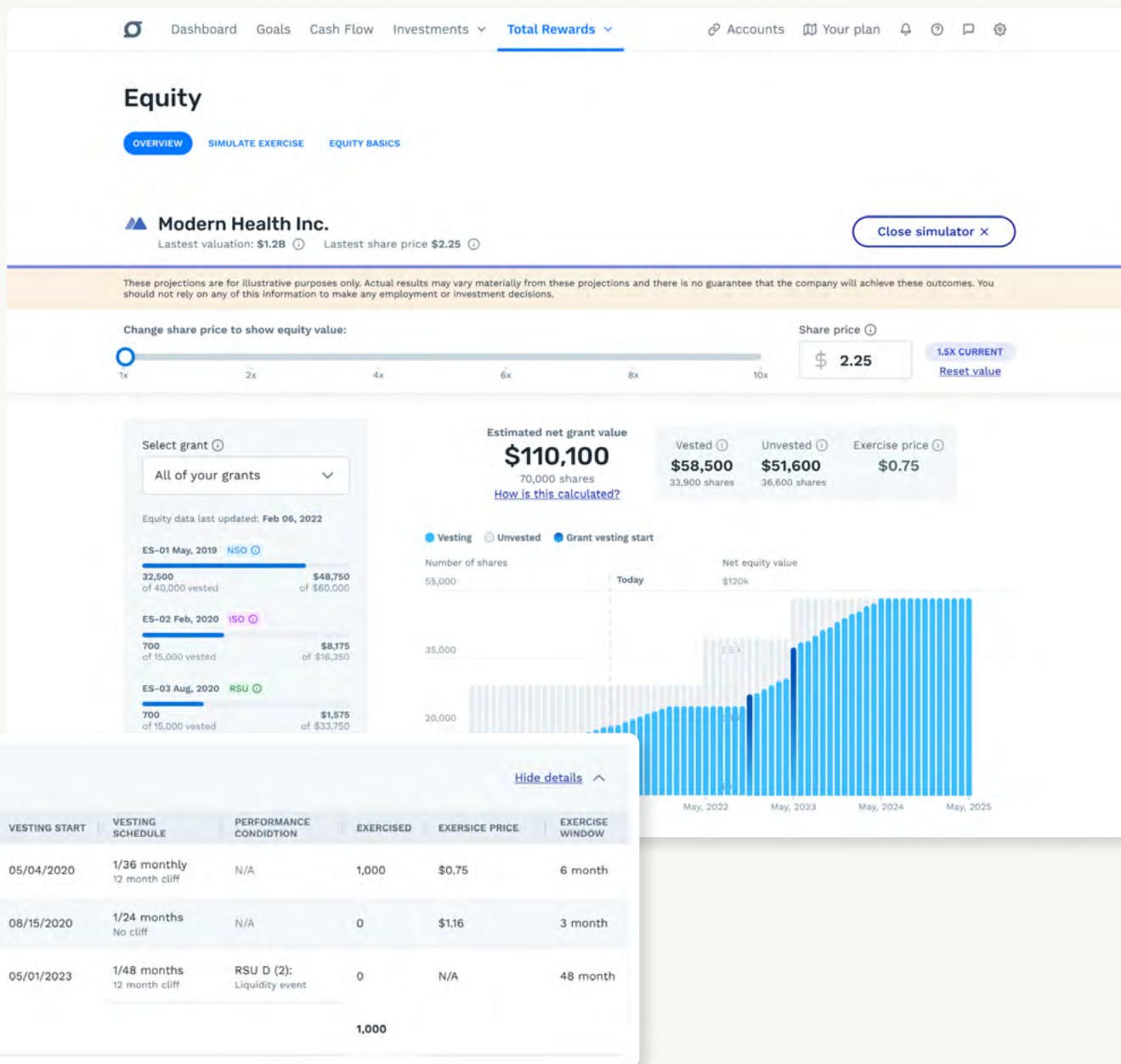
Partner with Origin

Many companies who offer employee equity compensation introduce a financial wellness benefit (like Origin) to help employees navigate their equity compensation.

Origin's Equity Manager product contains a suite of tools that allows your employees to get a comprehensive overview of their equity, educate themselves, and even simulate the value of their compensation over time.

Our product, paired with personalized guidance from CFP® professionals, empower your workforce to make the most informed and confident decisions possible around their equity compensation.

Navigating the world of equity compensation is far from easy. But we hope, with the help of this guide, the topic feels more accessible and less overwhelming. By taking the time to learn the basics of different types of equity—from the tax implications to the most common vesting schedules—you can feel more empowered to educate your own employees and, as a result, promote their financial wellbeing.





Find out how much your employee equity is really worth with Origin

Origin is a comprehensive financial wellness platform that helps employees manage their compensation, benefits, and personal finances—all with the personalized guidance of financial professionals.

By combining cutting-edge technology with the expertise of real humans, we help companies support the financial journeys of their workforce, every step of the way. If you want to learn more about Origin's Equity Manager, and how this product can help your employees navigate their equity compensation, [request a demo.](#)



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