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Employee Stock Benefits

By Xenia Woltmann

Employee stock options or purchase plans are offered by many employers. With so many types of plans, it can be confusing to determine how participating in the plan works. Understanding the benefits, downsides, and taxation of your individual plan is important to ensure that you are making the right decision. While each plan has its own provisions, below is a brief explanation of a few different plans that are available.

Employee Stock Purchase Plan (ESPP) – Perhaps the most common stock ownership plan available is the ESPP. Employers allow participating employees to purchase company stock at a discounted price. Employees elect a certain percentage to be contributed through payroll deductions between the offering date and purchase date. These timeframes vary based on the plan. The discount may be up to 15% in some circumstances and may be based on the offering date or the purchase date. Taxation is based on whether the plan is qualified (pre-tax contributions) or nonqualified (after-tax contributions). This can be tricky depending on the purchase price and when shares are sold.

Restricted Stock – Restricted stock is sometimes issued to executives and directors of corporations. They are non-transferrable and have strict trading rules. Restrictions may include performance targets or a vesting schedule to prevent employees from selling shares at a time that might negatively impact the company. There are two types of restricted stock: Restricted Stock Units (RSU's) and Restricted Stock Awards (RSA's). RSU's are not actually stock, just the promise of a stock which carry no voting rights. RSA's are actual shares, so they do carry voting rights. Restricted stock is taxable as ordinary income in the year it vests. Restricted stockholders also pay capital gains tax (or losses) on the difference between when the stock vests and when it is sold.

Employee Stock Ownership Plan (ESOP) – Similar to a profit-sharing plan, an ESOP qualifies for tax benefits provided certain rules are followed. They are common in closely held companies and are normally created when a retiring owner wants to transfer ownership to employees, or when the company needs to borrow money at a lower cost (ESOPs have borrowing capabilities). In an ESOP, the company contributes its own stock, or cash to purchase stock, to a trust designed to benefit employee retirement plans. Vesting usually occurs in 3-6 years. Contributions made by the company are tax-deductible. When the employee leaves, they receive their stock, which is bought back by the company at the current fair market value. Those funds can be rolled over into an IRA or another retirement plan.

Employee Stock Options (ESO) – These allow company employees and executives to purchase stock at a predetermined price (grant price or strike price). There are time limits to purchase the stock and tax considerations based on the type of option; the terms are dictated by contract provisions. ESOs also have a vesting period, meaning that the employee must be employed for a certain amount of time before they are able exercise the option (buy the stock). Deciding when to buy the stock is also a factor based on the current stock price and the company's outlook. For example, an employee is offered 1,000 shares of stock with a grant price of $20 per share. However, they must be employed for 2 years before they are able to purchase the stock. After 2 years, the current price is $25 per share. The employee may purchase the shares at $20 per share ($20,000) and immediately sell them at $25 per share, creating a $5,000 gain. (One thing to note is that many companies do not require the employee to pay out of pocket to purchase the shares in an immediate sale. Rather, the transaction is handled in-house to simplify things.) If the current share price is below $20 per share, it does not make sense to purchase the stock at that time and the employee can wait until the price rises if it is before the option expiration date (usually 10 years after the grant date). The employee may also decide to purchase the stock and hold on to it in hopes that the price will increase further.

Taxation of an ESO is based on the type of stock option. Most employees have **Non-Qualified Stock Option (NQSO).** These options require the employee to pay taxes on the difference between the grant price and the market value at the time of purchase, regardless of whether the employee sells the shares. The gain is taxed as ordinary income as it is

considered a form of compensation. In the example above, the employee would have been subject to taxes on $5,000. Additional taxes, in the form of capital gains, are paid on the difference of the purchase price and value at the time of the sale. Shares held less than one year are subject to short-term capital gains while shares held one year or longer are subject to long-term capital gains.

The other type of ESO is called an **Incentive Stock Option (ISO), which is also called Qualified Stock Option (QSO).** These are usually offered to executives and **ISOs** have special tax treatment. These options are not taxed at the time the stock is purchased (option is exercised) but are taxed as capital gains when the shares are sold. (While ISOs are not taxable at the time of the purchase, the transaction could trigger the alternative minimum tax (AMT). In 2021, individuals with income over $73,600 or couples filing jointly with income over $114,600 could be subject to the AMT which phases out income exemptions (This is another topic altogether.)

Stock Appreciation Right (SAR) SARs work in a similar fashion to ESOs in the sense that they provide a profit to the employee when the stock price rises. What is unique about SARs is that the employee does not transact actual shares of stock, which is beneficial to the company and shareholders because additional shares do not need to be issued which would dilute the share price. Also, the employee will receive SARs which may have a vesting period. Just like the previous example, an employee with 1,000 SARs at a value of $20 per share, or $20,000, can choose to exercise the right at two years ($25 per share) which would provide $5,000 in income, or wait until a future date. When the right is exercised, the gain between the grant price and exercise price is taxed as ordinary income and is almost always paid in cash. The employee does not hold shares beyond the exercise price so it is important to exercise the right when they want to realize the gain. SARs are subject to vesting and “clawback” provisions meaning that if they leave the firm, they may forfeit the right. Some companies offer SARs alongside ESOs to provide cash so that an employee desiring to take advantage of exercising the ESO and hold the stock can afford to do so; these are called tandem SARs. As with other forms of stock plans, company terms apply.

Phantom Stock, or Shadow Stock Similar to SARs, phantom stock allows companies to give certain high-level employees a benefit of stock growth without holding shares. The employee receives a “mock stock” issued either as a specific number of units, or a participation percentage interest. This stock follows the actual stock price movement without diluting actual stock shares. **Full Value** phantom stock plans pay the employee the value of the stock, as well as the gain as if they were selling the shares in an open market. **Appreciation Only** plans pay only the difference between the grant price and the payment date. Terms of payment are different based on plan specifications, but usually contain a vesting schedule and payment date. An example is if an employee receives 100 shares of phantom stock with a starting value of $10 per share, or $1,000. Once all terms are met, the employee’s shares are redeemed. The share value on the payment date is $15. In an appreciation only plan, the employee will receive cash compensation of $500 ($1,500 current value - $1,000 initial value). In a full value plan, the employee will receive the full $1,500. Most phantom stock plans do not allow employees to choose a redemption date. It is pre-determined by the employer because different rules apply to phantom stock plans versus stock option programs. While the plan details are complex, the payments are taxable as ordinary income.

By allowing employees to participate in earnings, many firms can onboard and maintain quality employees. There are numerous benefit plans available, each varying based on the company. Read the details and consult with your HR department or an expert to understand how they work, if they are in your best interest and if they may play a role in your financial plan.

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