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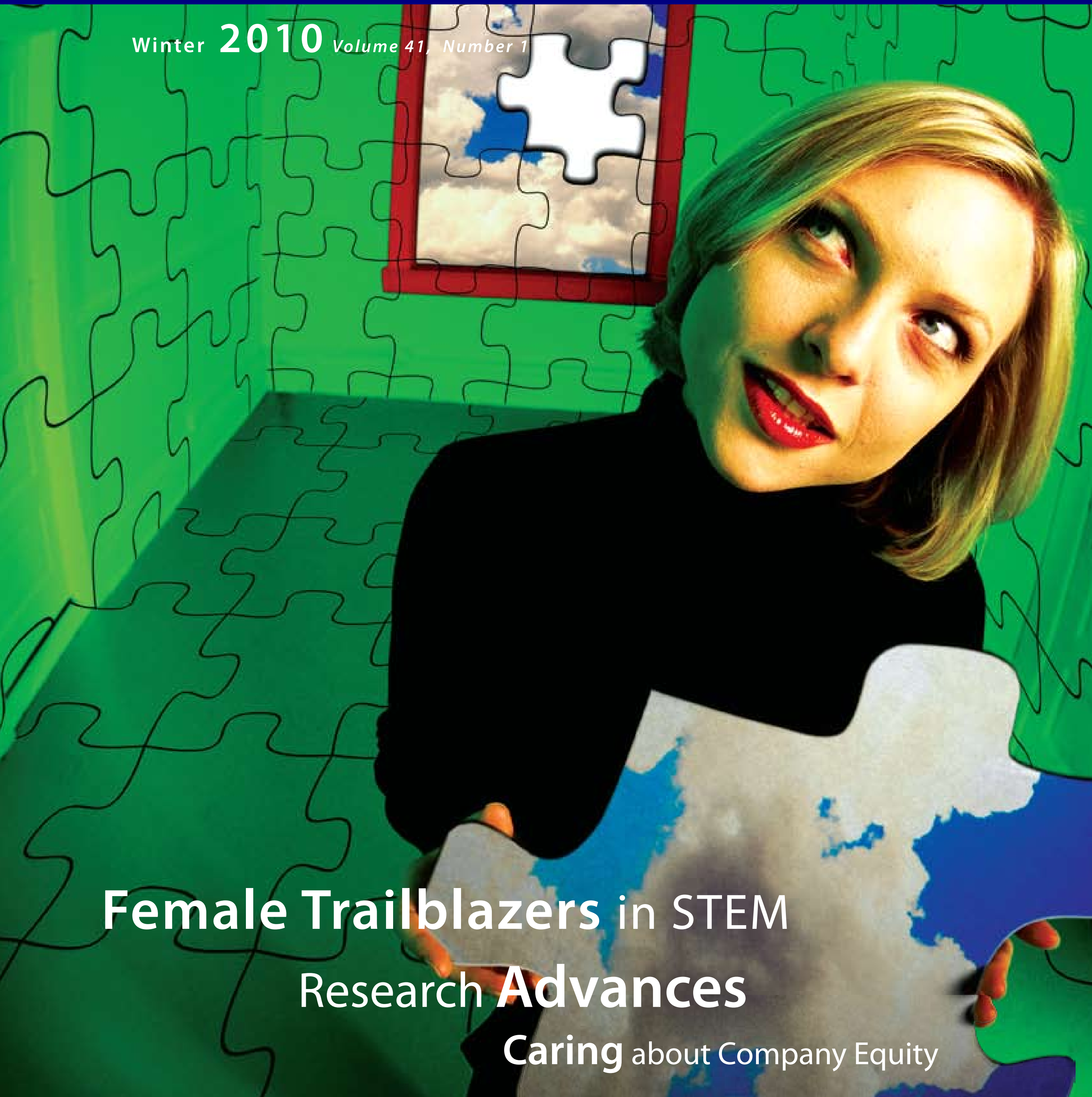

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Be the First to Understand and Care about Company Equity

By Edi Alvarez

Employers establish company equity plans to foster a connection between your work and the success of the company. These plans may provide you with access to equity through stock purchases or an opportunity to purchase equity at a future date through stock options. Ideally, company equity will grow throughout your tenure. The thought is that this opportunity entices talent to the firm, keeps costs down, and motivates, retains, and inspires employees. Even so, individuals don't participate in company equity plans and even in favorable markets let stock options expire. Why?

The reasons for nonparticipation include: "No time to deal with it," "don't understand the value," and "judged the market risk too high compared to potential return." In the Bay Area, some AWIS members had this to say about company equity: "Company equity? Yeah, HR rattled off a bunch of acronyms the day I started"; "I know one of them is vesting soon, but I haven't really had time to look into it"; "I decided not to participate because I don't have the money. Besides, I'm already maximizing my 401(k). That's plenty and a lot safer. I mean, company equity is just a way to keep my salary low, right? Why should I participate?"

Sound familiar? I was pleased to find that some of you are "old hands" at company equity plans, but some answers convinced me that I should start with a refresher.

Company equity plans are a way for employees to access company shares even while the company is privately owned. Some plans are available only to upper level or key employees, while others are available to all employees. Stock option plans, once granted, give the qualifying employee the right to buy the firm's stock after a set period of time (the vesting period) and for a fixed amount of time before they expire.

AWIS members interviewed participate in different company equity plans, including Incentive Stock Options (ISO), Non-Qualified Stock Options (NQSO), and the Employee Stock Purchase Plan (ESPP). Some have been awarded Restricted Stock Units (RSU), which are commonly offered by large multinational companies and are becoming more popular. Several individuals interviewed benefited from restricted stock awards, which are a form of compensation for owners and upper-echelon personnel. The only commonly used equity plan that was not mentioned was the ESOP (Employee Stock Ownership Plan), which works like a 401(k) plan but invests in company stock.
As mentioned, employers offer these plans to motivate employees through the power of ownership, yet many respondents intimated that their main reasons for remaining at a particular company was earning a good salary with other nonequity benefits. Others cited less tangible reasons such as the freedom to direct their own workload or the value in the intellectual challenge. Despite these nonfinancial reasons, as we look for ways to support our personal goals we invariably lean toward firms that help us build a solid financial future while providing for professional growth. Company equity purchase plans can be an important part of that equation. For some, company equity has already provided the key to financial independence.

Where to start?
Here are four important steps to consider:

1. Become familiar with the available equity plans. I'll briefly review the three most commonly mentioned plans: ISO, NQSO, and ESPP (I'll save for another discussion ESOP, RSU, and phantom stock plans). The first two are stock options, which carry the most flexibility, and the third allows for monthly purchase of company shares at a discount. Stock-option plans give you the right to purchase stock at a price some time in the future (when they vest). The vesting time is set by the company (usually 2-5 years), at which point you have the right to exercise your options and purchase shares. Along with knowing about market risk, you need to be aware of tax consequences (see table on tax comparison). The plans' tax consequences are highlighted in the table below.

■ ISO have very strict rules on when you can exercise them and who can own them. If you work within the rules, they have favorable tax consequences but can trigger Alternative Minimum Tax (AMT). Also, holding the stock prior to sale for at least one year after purchase and two from the grant date results in a lower tax rate but does expose you to market and company risk.
■ NQSO have less restrictive rules and can be awarded to nonemployees, like consultants. Because they do not qualify for preferred tax treatment, they have two tax points. One occurs when you exercise the option, and the other when you sell it. Notice that you don't need to sell to assume tax liabilities.
■ ESPP is an excellent way to slowly grow your savings while working at an established publicly traded firm. Though these plans differ, I have encountered many that allow employees to contribute after-tax income during an offering period. At the end of the offer period, stock is often purchased at a discount (5-15%). Many will also offer a "look-back" provision that uses a lower earlier price. Another advantage of qualified ESPP is that tax liability exists only after they are sold. Sometimes a good strategy is to sell your stock immediately and collect the after-tax profit; however, many plans will not allow immediate sale.

2. Read the plan document and identify the important components. Options are a great way to control the recognition of taxable income and market risk because you do not own the stock until you exercise the option. To do this, you must know how your individual plan works. How will your equity change if there

Type of Equity	At Grant	On Vesting	On Exercise	On Sale
ISO	No	No	Not usually, but may have AMT	Yes
NQSO	No	No	Yes, at your income tax rate	Yes
RSU	No	Yes, if not deferred		Yes
ESPP	No		Not usually	Yes
Nonqualified ESPP	No		Yes, at your income tax rate	Yes

Table 1. Tax Consequences of Granted Company Equity

is a liquidity event or corporate restructure? What are the rules on when you can or can't use this equity?

When reading your stock-option agreement, I encourage you to record at least the following information: What type is it? What is the vesting schedule? How will the price be set? When will they expire? What are the restrictions and limitations to buying/selling your stock? Will they automatically withhold taxes? And if so, at what rate? What happens when your job ends? How will your options change if your company changes ownership?

You will want to know at least the following information about your company's ESPP: What discount will you receive? How is the price set? Does it have look-back? When is the offer period? How and when can you reverse the purchase? What are the selling rules (can you sell on the same day as you buy the stock)? And, are there any restrictions and limitations? What will happen if there is a corporate restructure? What happens if your job ends?

3. Be clear about your goals. Know the reasons for investing in company equity. The purpose is to ensure that your emotions don't lead you into costly mistakes.

4. Establish a schedule and identify your triggers. If your goal is to spend the proceeds of each sale for a specific purpose, that amount has an impact on the "trigger" to exercise and sell. You can easily set the stock price that will be your trigger if your spending goal is clear. Depending on your situation, you may play it safe and exercise and sell at the same time. An alternative is to exercise and hold the stock long term. This is often intended to lower taxes or to meet a vesting requirement. Remember, the moment you choose to hold onto company stock, you are making a decision to carry company risk – make certain this fits with your goals. In some cases, it is ideal to exercise as late as possible and immediately sell. Others will be required to exercise options on a regular schedule.

In summary, if your plan allows, hold the option but not the stock, at least until you are ready to use the profits or if the options are close to expiry. This strategy works well but carries higher tax consequences and needs to fit in your overall financial plan. ESPP provides a slow and steady saving opportunity as long as company stock is not overvalued. If your company's ESPP has reasonable provisions, then consider participating, but always set your triggers and have an exit plan.

But what about your 401(k) plan? How do "stock option" plans dovetail, if at all, with retirement saving plans? If your employer provides a match to your 401(k) plan, then you should be contributing enough each year to earn the entire employer match. Beyond the portion that is guaranteed to receive a match, your next best investment is dependent on your specific situation. So ask yourself: How close are you to retirement? How well does your 401(k) perform compared to your company stock? Is your company currently undervalued? These are important considerations that are specific to you. In some cases, equity plans are a better way to reach your goals, but at other times the tax-deferred earnings inside a low-cost retirement plan may provide the best opportunity. Have someone guide you or spend the time to understand how company equity fits into your financial plan.

In the final analysis, your company equity plan can help support your core financial goals, force you to save, and provide an opportunity to invest in and get to know your company. It should be a part of how you evaluate existing and new employment opportunities.

Do your due diligence, plan your strategy, and follow through. Regardless of the type of equity offered by your employer, understanding your options (pun intended) and knowing your goals will allow you to maximize the opportunities for financial growth. ■

Remember finances are a very individual matter. My suggestions are intended only as a guide to understanding. They may not be appropriate for your specific situation. Thanks to everyone who so generously answered my questions and shared their experiences. You helped transform this column from one outlining the technical aspects of options to one that deals with company equity. Your continued feedback helps to make the Money Matters column relevant.

Finances can support or derail professional and family life. It is Edi's intention to be both a resource and advocate for our financial health. Edi is a Registered Investment Advisor in California and Certified Financial Planner™ providing financial services to individuals and businesses. She is a past president of the Association for Women in Science, San Francisco Chapter, and presently serves on the AWIS Finance Committee. Edi can be contacted at edi@aikapa.com.