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WATCH | Three Types of Incentive Compensation That Require Tax Planning

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Three Types of Incentive Compensation That Require Tax Planning

Employees at public companies with incentive compensation have unique planning needs. This is because there are several types of incentive compensation each with varying rules for vesting, purchasing, and selling. Navigating these rules requires tax-aware advice. Let's take a look at three types of equity incentive compensation awards.

Restricted Stock Units or RSUs are grants that automatically become tradable shares upon vesting. The tradable shares trigger ordinary income tax based on the securities fair market value as of the vesting date. The recipient has no control over the timing of the taxable event. As a result, advanced planning for the tax liabilities associated with the vested and unvested shares is essential. What's more? If the tradable shares appreciate after the vesting date and are sold in the future, capital gains tax would be owed on the appreciation.

Non-qualified Stock Options or NQSOs provide an opportunity to purchase company stock at a discount. These options vest over time. After they vest, and once they're exercised, the discount received on the stock is taxed as ordinary income. Vested options exercised with cash become tradable shares. If these shares are sold in the future, then capital gains taxes will be owed on any appreciation. Some employers may facilitate cashless exercise invested in QSOs. When this happens, the recipient receives a bargain element, this is the cash proceeds of the discount minus withholdings for taxes owed. Unlike RSUs, the recipient can control the timing of exercising NQSOs. This allows for more flexibility in planning for the taxable events.

Incentive Stock Options or ISOs are employer stock options that qualify for a deferral of any tax payment until the acquired shares are sold. Just like NQSOs, the recipients can choose when to exercise unexpired vested options. ISOs offer different tax treatments than NQSOs. Working with an advisor before exercising options is important when someone has this type of compensation.

It's not uncommon for employees to accumulate concentrated positions of company stock from these plans. Talk to your clients to determine if they have concentrated positions so you can recommend tax-efficient strategies for helping them diversify their holdings. Conversations about incentive compensation plans can lead to tax planning strategies that potentially maximize the value of these plans for employees.

Take a few minutes to explore the Eaton Vance Tax Education Center at EatonVance.com/TaxEdCenter for more useful resources to help you meet a variety of tax-forward investing needs.

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