Morgan Stanley

PRIVATE WEALTH MANAGEMENT

Insights for Entrepreneurs

Part Seven: Understanding Equity Compensation

Working as part of an integrated advisory team, your Morgan Stanley Private Wealth Advisor can help you make well-informed personal wealth management decisions at every stage of your company's development. Our goal is to provide you with the information, insight and resources needed to help you reach your personal and professional goals. We are here to help you answer the key questions that arise at the intersection of your business strategy and your personal wealth management.

Why Do I Need to Know About Equity Compensation?

Depending on your ultimate exit strategy, you may reach a point where the better part of your net worth is held in the form of publicly traded stock and options. This may be the result of taking your company public, or of merging with, or being acquired by, a publicly listed corporation. You may have to manage different types of incentive compensation, and decide when, how and if you want to divest some of these assets to diversify your overall holding and pursue your future business, philanthropic and wealth transfer goals.

What Is Restricted Stock?

Two of the more popular stock bonus structures today are restricted stock units (RSUs) and restricted stock awards. RSUs are an unfunded promise to issue a specific number of shares, or a cash payment, at a future time when vesting conditions have been satisfied. Cash-settled RSUs are much less common than stock-settled RSUs because they are subject to unpopular variable accounting. Restricted stock awards are also used to reward employees with grants of stock. They generally vest over time and can be subject to forfeiture if the employee leaves the company or does not meet stipulated performance objectives. Unlike RSUs, restricted stock awards generally come with voting rights because the employee actually owns the stock the moment it is granted.

What Is the Difference Between My Two Types of Stock Options?

There are two types of options that companies grant to their employees: nonqualified stock options (NQSOs) and incentive stock options (ISOs).

The more commonly granted NQSOs do not qualify for special favorable tax treatment. When an NQSO is exercised, the spread (difference between strike price and fair market value on date of exercise) is considered to be compensation income and is reported on IRS Form W-2. The company will withhold income tax, Social Security tax and Medicare tax. When the shares are sold, the proceeds are taxed under the rules for capital gains and losses.

Unlike NQSOs, ISOs qualify for special tax treatment under the Internal Revenue Code, as long as they meet rigid criteria under the tax code. ISOs can be granted only to employees, not to consultants or contractors, and there is a $100,000 per-employee limit on the aggregate grant value of ISOs that may first become exercisable in any calendar year. Any employee leaving the company must exercise his or her ISOs within three months of such termination in order to retain the special ISO tax benefits.

After you exercise ISOs, if you hold the acquired shares for more than two years from the date of grant and more than

one year from the date of exercise, any appreciation over the exercise price is generally considered long-term capital gains. However, the paper gains on shares acquired from ISOs and held beyond the calendar year of exercise can subject you to the alternative minimum tax (AMT). This can be problematic if you are hit with the AMT on theoretical gains, but then the company's stock price plummets, leaving you with a big tax bill on income that has evaporated.

Can I Gift Options?

Although it is possible to gift options, the approach normally entails a degree of complexity that is not present when gifting shares of company stock. For example, ISOs must, by definition, be nontransferable during the option-holder's lifetime. As a result, gifting opportunities are normally limited to NQSOs. Even within the context of NQSOs, gifting can only take place if permitted under the terms of the company stock plan.

Once Our Stock Is Publicly Traded, What Considerations Come Into Play?

If an IPO or sale leads to a substantial concentrated position in your company's stock, you will need to address a series of issues with important legal, tax and business implications. As it is important that these issues be considered within the context of your overall wealth planning goals, it is advisable to discuss your options with your Private Wealth Advisor. Principal among these questions is whether you should liquidate the stock and, if so, how can you do it in an orderly and tax-efficient manner?

- If you decide to liquidate, you should be aware of any regulatory (144/16b), corporate (blackout periods) or contractual (lock-up agreements) restrictions that may be imposed on the amount of stock you can sell in any given quarter;
- If possible, you may want to consider engaging in a hedging transaction to mitigate the risk of holding your concentrated position;
- You may wish to consider a 10b5-1 plan to sell stock in a methodical manner and mitigate claims of insider trading;
- Once liquid, you may wish to consider reinvesting the proceeds to mitigate the risk of your concentrated position. For instance, you may wish to invest away from the sector in which your company operates.

THE INSIGHTS FOR ENTREPRENEURS SERIES COVERS THE FOLLOWING ADDITIONAL TOPICS:

- Choosing a Business Structure
- Early-Stage Trust and Estate Planning
- Overview of Wealth Planning Structures
- The Public Sale of Privately Held Businesses
- Family-Owned Business Succession Strategies
- Philanthropic Strategies and Structures

FOR FURTHER INFORMATION

If you wish to discuss issues specific to your equity compensation, including strategies to diversify a concentrated position, please speak to your Private Wealth Advisor. He or she can help you make informed decisions on which strategies may be best-suited to helping you achieve your personal and professional goals.

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