BakerAvenue
WEALTH MANAGEMENT

Tax Planning for Employees with Equity Compensation

(RSUs, NSOs, ISOs, and ESPPs)

by Koji Iwata, EA, Senior Tax Preparer

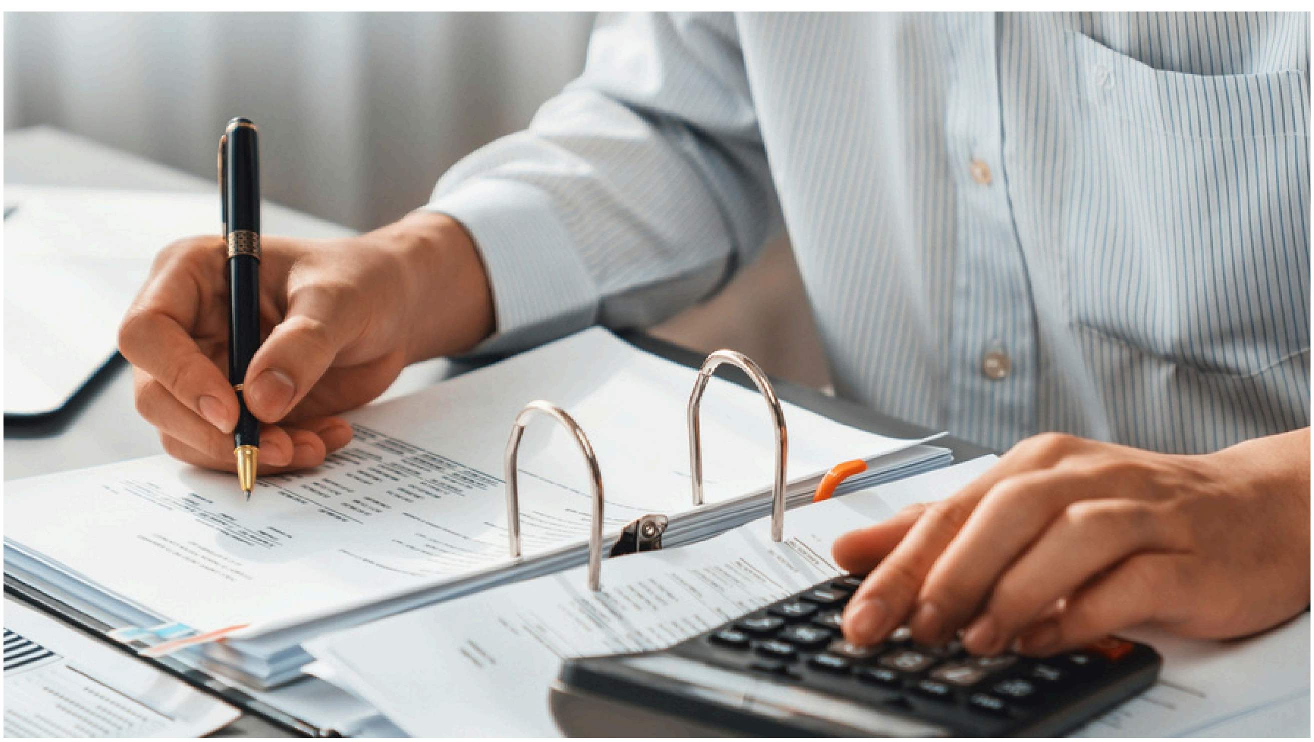
Many employees may receive a significant portion of their compensation through equity-based incentive programs. While these arrangements can create substantial wealth, they also introduce tax complexities that are uncommon in traditional salary-and-bonus compensation structures.

For many professionals, annual tax liabilities are driven less by cash compensation and more by RSU vesting, NSO and/or ISO exercises, ESPP transactions, and concentrated positions in employer stock. As compensation increases, taxpayers may encounter withholding shortfalls, Alternative Minimum Tax (AMT), and multi-state tax considerations.

At BakerAvenue, we often find that the better outcomes may occur when tax planning, investment management, cash-flow forecasting, charitable planning, and estate planning are coordinated as part of a unified strategy rather than addressed independently.

Five Key Elements

- Equity compensation often drives tax liability more than salary.
- Employer withholding may be insufficient to cover the ultimate tax liability.
- Exercise and sale timing can significantly affect taxes, AMT exposure, and cash flow.
- Proactive planning before vesting, exercising, or selling shares often creates meaningful planning opportunities.
- Effective equity compensation planning requires balancing tax efficiency, diversification, liquidity needs, charitable goals, and long-term wealth preservation.

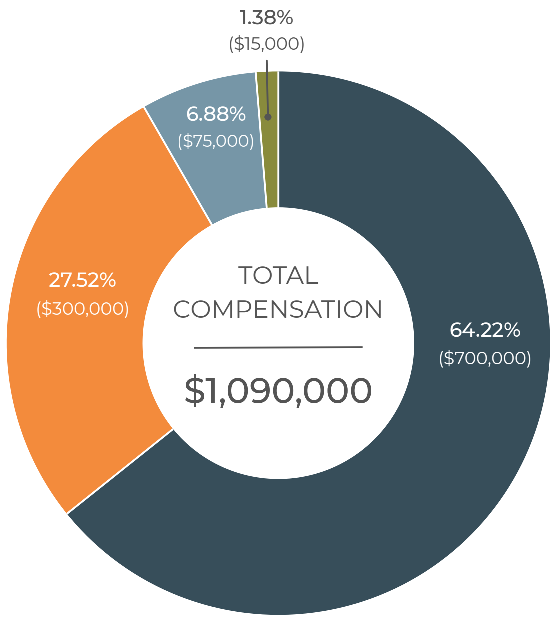


Understanding the Tax Profile

A common misconception among employees is that their tax situation is driven primarily by salary. In reality, equity compensation often becomes the dominant component of taxable income.

Figure 1 illustrates a hypothetical compensation structure for a senior director at a technology company. It demonstrates that equity compensation dominates total compensation.

Figure 1 Income Composition: Equity Compensation Dominates



Compensation Component	Amount	% of Total
RSUs (at Vesting)	$700,000	64.22%
Salary	$300,000	27.52%
Annual Bonus	$75,000	6.88%
ESPP Income	$15,000	1.38%
TOTAL COMPENSATION	$1,090,000	100%

Equity compensation represents 65.60% of total compensation.

Planning for equity income is essential for effective tax management.

Although salary represents less than one-third of total income, many employees continue to focus their planning efforts on payroll withholdings while overlooking the tax consequences of equity compensation.

Understanding the timing and character of each compensation component is often the starting point for effective planning.

Restricted Stock Units (RSUs)

For many employees, RSUs represent the largest source of taxable income. Upon vesting, the fair market value of the shares is treated as compensation income and reported on Form W-2. The employee recognizes ordinary income regardless of whether the shares are retained or sold. This creates several planning issues:

Taxable Income Volatility

Employees may experience significant increases in taxable income merely because of stock price appreciation.

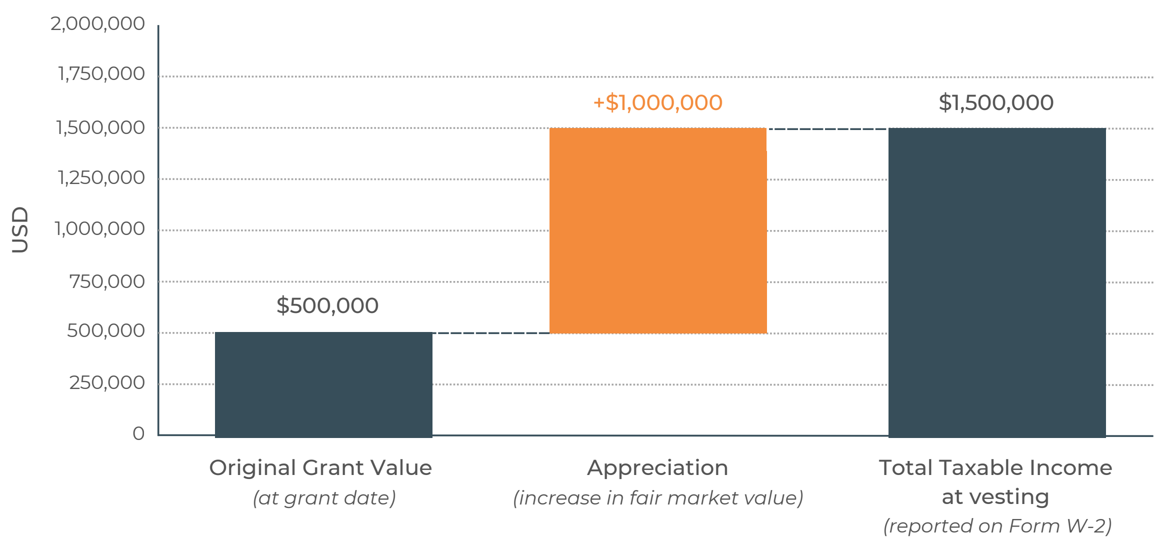
For example:

- Grant: **10,000 RSUs**
- Grant price: **$50**
- Vesting price: **$150**

In this hypothetical example (Figure 2), the employee recognizes $1.5 million of compensation income despite the grant originally having an estimated value of $500,000.

Figure 2 How RSU Appreciation Magnifies Taxable Income

A rising stock price can dramatically increase W-2 income without any change in salary.



In this example, a 3x increase in stock value results in $1,000,000 of additional taxable income – without any additional cash compensation.

Original Grant Value	$500,000
Appreciation	+$1,000,000
Total Taxable Income	**$1,500,000**

Marginal Tax Rate Management

Large vesting events can trigger:

- Up to 37% federal marginal rate
- Additional Medicare Tax (0.9%)
- Net Investment Income Tax on interest, dividends, and capital gains (3.8%)
- State income taxes (for example, up to 13.3% for California)

The combined federal and state marginal rate can exceed 50% in certain jurisdictions.

Estimated Tax Exposure

Employers withhold federal income tax on supplemental wages, including RSU income and NSO exercise income, at a flat 22% rate when the employer uses the IRS percentage method.

However, once supplemental wages paid by the employer exceed $1 million during the calendar year, withholding generally increases to 37% on amounts above that threshold. Even at the higher withholding rate, additional tax payments may be necessary for high-income taxpayers.

For employees with substantial equity compensation, annual tax projections often become essential once compensation approaches seven figures.

Under-withholding and Safe Harbor Planning

One of the most common tax issues is under-withholding related to RSUs.

Although employers generally withhold taxes at vesting, as this hypothetical example shows, the withholding methodology often does not align with the taxpayer's ultimate marginal rate.

Figure 3 RSU Vesting: Why Withholding Often Falls Short

Example: $1,000,000 of RSU Income

Employers typically withhold federal income tax on RSU vesting using a flat supplemental wage rate (22%). Your actual tax liability is based on your true marginal tax rate and may be significantly higher.

Item	**Employer Withholding** *(Based on Supplemental Withholding Rate)*	**Actual Tax Liability** *(Based on Your Marginal Tax Rate)*
RSU Income (W-2)	$1,000,000	$1,000,000
Tax Rate Applied	22% *(Federal income tax rate used for withholding)*	37% *(Illustrative federal marginal tax rate)*
Federal Tax	$220,000 Withheld by Employer	$370,000 Your Actual Federal Tax Liability
! Additional Tax Due (At Filing)	–	$150,000 ($370,000 - $220,000)

You could owe an additional $150,000 when you file your tax return.
This amount may also be subject to underpayment penalties and interest.

Standard withholding assumes a lower tax rate. Proactive tax planning and estimated payments can help you avoid surprises and keep more of your hard-earned wealth.

Note: This example illustrates federal income tax only. State taxes, Additional Medicare Tax, and other taxes may increase your total liability.

Common consequences include:

- Unexpected balances due
- Underpayment penalties
- Cash flow strain

A key planning objective is determining whether the taxpayer has met one of the federal estimated tax safe harbors:

- 90% of current-year tax liability, or
- 100% of prior-year tax liability (110% for higher-income taxpayers)

For high-income employees with substantial equity compensation, proactive quarterly estimated tax payments are often preferable to addressing significant shortfalls at filing time.

Non-Qualified Stock Options (NSOs)

Non-Qualified Stock Options (NSOs, sometimes referred to as NQSOs) provide employees with the right to purchase company stock at a predetermined exercise price (often called the strike price). Unlike RSUs, NSOs generally do not create taxable income upon grant or vesting. Instead, taxation typically occurs when the option is exercised.

Taxation at Exercise

When an employee exercises an NSO, the difference between the stock's fair market value and the strike price (the "spread" or "bargain element") is treated as ordinary compensation income and is generally reported on Form W-2.

Example:

Item	Amount
Exercise Price	$20/share
Fair Market Value at Exercise	$80/share
Spread Subject to Ordinary Income	$60/share

If the employee exercises 10,000 options, the resulting compensation income would be $600,000.

After exercise, any subsequent appreciation or depreciation is generally recognized as capital gain or loss when the shares are sold.

Exercise Timing as a Planning Opportunity

Unlike RSUs, NSOs allow employees to control the timing of the taxable event, making exercise decisions one of the most important planning opportunities available within an equity compensation program.

Factors that may influence exercise decisions include:

- Expected future stock appreciation
- Availability of cash to fund the exercise
- Current and projected marginal tax rates
- Concentration risk in employer stock

In some situations, exercising earlier may reduce future ordinary income exposure if the stock continues to appreciate. In other cases, delaying exercise may be appropriate when liquidity is limited or future stock performance is uncertain.

Cash Flow Considerations

Unlike RSUs, which often involve no out-of-pocket purchase cost, NSO exercises generally require employees to fund:

- The strike price of the options
- Applicable federal and state tax withholdings

For large exercises, the combined cash requirement can be substantial. As a result, employees frequently consider alternatives such as cashless exercises or same-day sales to generate liquidity and satisfy withholding obligations.

Withholding and Estimated Tax Considerations

Similar to RSUs, NSO exercises can create significant withholding shortfalls when compensation income is large relative to statutory withholding rates. As a result, estimated tax projections and safe harbor analysis may be appropriate before substantial exercises.

Expiration Risk

NSOs typically expire ten years after the grant date, although termination of employment may significantly shorten the exercise window. Unexercised options that expire generally become worthless.

Accordingly, periodic reviews of outstanding option grants are important to avoid forfeiting valuable compensation.

Key Planning Considerations

For employees with significant NSO holdings, tax planning often focuses on:

- Timing exercises across multiple tax years
- Managing marginal tax brackets
- Evaluating withholding sufficiency
- Coordinating diversification strategies
- Planning for liquidity needs
- Monitoring option expiration dates

When managed proactively, NSOs can provide significant flexibility relative to other forms of equity compensation, but they also require careful coordination among tax, investment, and cash flow planning decisions.

Incentive Stock Options (ISOs) and Alternative Minimum Tax

Although less common than RSUs, many employees continue to receive or hold Incentive Stock Options (ISOs). An ISO gives an employee the right to purchase company stock at a predetermined exercise price. ISOs may qualify for favorable long-term capital gain treatment if certain holding period requirements are satisfied.

However, these potential tax benefits come with Alternative Minimum Tax (AMT) considerations, where AMT is a parallel tax system that can result in additional tax liability beyond the regular income tax calculation. (While Incentive Stock Option is the formal name, it is sometimes referred to as a Qualified Stock Option.)

ISO Exercises and AMT

Unlike NSOs, exercising an ISO generally does not create regular taxable income if the shares are retained. However, the difference between the fair market value and the exercise price (the "bargain element") is included in AMT income.

Example:

Item	Amount
Exercise Price	$100,000
Fair Market Value	$500,000
AMT Adjustment	$400,000

As a result, a taxpayer may owe substantial AMT despite receiving no cash from the transaction. This can create significant liquidity and cash flow challenges. An ISO exercise can generate tax liability without a corresponding sale of shares.

Exercise Timing as a Planning Opportunity

Because ISO exercises are generally elective, employees often have opportunities to manage AMT exposure by:

- Spreading exercises across multiple years
- Limiting annual exercises to remain within acceptable AMT levels
- Coordinating exercises with other forms of income, such as RSUs, to achieve AMT-free exercises
- Evaluating exercises after stock price declines
    - For options that permit early exercise, making a timely Section 83(b) election may reduce future ordinary income exposure and accelerate the start of capital gain holding periods. (This topic is described in more detail in a separate white paper, IPO Planning to Optimize Your Stock)

Proactive modeling is often essential before exercising large option positions.

Qualifying vs. Disqualifying Dispositions

To receive favorable tax treatment, ISO shares generally must be held:

- More than 2 years from the grant date, and
- More than 1 year from the exercise date

If both holding periods are met, the entire gain from the exercise price to the sale price is generally taxed as long-term capital gain. The potential for long-term capital gain treatment is one of the primary tax advantages of ISOs relative to NSOs.

Selling before either holding period is satisfied results in a disqualifying disposition, causing part of the gain to be taxed as ordinary income. However, an earlier sale may still be appropriate to reduce concentration risk, improve liquidity, or support broader portfolio objectives.

Figure 4 summarizes the hypothetical tax consequences of qualifying and disqualifying dispositions.

Figure 4 ISO Exercise - Potential Tax Outcomes

ISOs can provide long-term capital gain treatment, but the tax outcome depends on holding period compliance and the decision to sell.

Exercise ISO

You purchase shares at the exercise price.
The bargain element (FMV minus exercise price) may create AMT liability in the year of exercise.

Path 1: Qualifying Disposition

Favorable Long-Term Capital Gain Treatment

1) Potential AMT at Exercise

The bargain element (FMV minus exercise price) is included in AMT income.

2) Hold Shares

You hold the shares after exercise.

3) Meet Both Holding Period Requirements

- *More than 2 years from the grant date, and*
- *More than 1 year from the exercise date*

4) Qualifying Disposition

You sell the shares after meeting both holding period requirements.

5) Tax Result

The entire gain (sale price minus exercise price) is generally taxed as long-term capital gain.

Path 2: Earlier Sale (Disqualifying Disposition)

Alternative Tax Treatment

1) Potential AMT at Exercise

The bargain element (FMV minus exercise price) is included in AMT income.

2) Sell Before Holding Periods Are Met

You sell the shares before meeting one or both holding period requirements.

3) Earlier Sale/Disqualifying Disposition

Holding period requirements are not satisfied.

4) Tax Result

- *The lesser of (a) the bargain element at exercise or (b) the gain at sale is taxed as ordinary income.*
- *Any remaining gain (if any) is taxed as capital gain (long-term or short-term based on holding period).*

5) Considerations

An earlier sale may be appropriate to reduce concentration risk, generate liquidity, or support other investment goals.

Tax outcomes are important, but investment, diversification, and liquidity objectives should always be evaluated alongside tax considerations.

Post-Termination Exercise Window

Employees should also be aware that ISOs generally retain ISO status only if exercised within 90 days after termination of employment (or up to one year in certain disability situations). Options exercised after the applicable deadline generally lose ISO treatment and are currently taxed under rules applicable to non-qualified stock options (NSOs). Because many employees receive a limited post-employment exercise window, option review should be part of any job transition or retirement planning analysis.

AMT Credit Carryforwards

Taxpayers who previously paid AMT due to ISO exercises may generate AMT credit carryforwards that can offset future regular tax liabilities. These credits should be reviewed periodically as part of the tax planning process.

Key Planning Considerations

For employees with significant ISO holdings, planning often focuses on:

- Managing AMT exposure before exercising
- Determining annual exercise capacity
- Evaluating qualifying versus disqualifying dispositions
- Monitoring concentration risk
- Reviewing AMT credit carryforwards

When coordinated effectively, ISO planning can help employees balance tax efficiency, liquidity, and investment diversification objectives.

Employee Stock Purchase Plans

While Employee Stock Purchase Plans (ESPPs) can provide employees with an attractive opportunity to acquire company stock at a discount, they typically represent a smaller component of overall compensation than RSUs, NSOs, and ISOs.

The tax treatment of ESPP shares depends largely on how long the shares are held before sale. Sales may result in a combination of:

- Ordinary income
- Short-term capital gain
- Long-term capital gain

In general, shares sold after satisfying the applicable holding period requirements may receive more favorable tax treatment than shares sold earlier.

Planning Insight

Although qualifying dispositions can produce tax benefits, employees should avoid allowing tax considerations alone to dictate ESPP holding periods.

For many employees, the more important considerations are:

- Maintaining appropriate portfolio diversification
- Managing concentration risk in employer stock
- Preserving liquidity and cash flow flexibility
- Aligning investment decisions with long-term financial goals

In many cases, selling ESPP shares shortly after purchase and redeploying the proceeds into a diversified portfolio may be a reasonable strategy, even if it results in less favorable tax treatment.

Concentrated Stock Positions and Tax-Efficient Diversification

While much of the discussion thus far has focused on income taxation, investment risk often becomes equally important as equity compensation accumulates. BakerAvenue offers a range of strategies for concentrated stock positions, which are discussed in greater detail in a separate white paper Concentrated Stock Comprehensive Guide. The goal is often to develop a disciplined multi-year diversification strategy with tax efficiency in mind, rather than pursuing a single large liquidation event.

Charitable Planning with Appreciated Employer Stock

Employees who hold highly appreciated securities may benefit from evaluating charitable gifting strategies.

Consider:

Cost Basis	FMV
$100,000	$1,000,000

A direct contribution of appreciated shares may allow the taxpayer to:

- Avoid capital gains tax on $900,000 of appreciation
- Receive a charitable deduction based on fair market value
- Reduce overall portfolio concentration

Donor-advised funds (DAFs) may be worth evaluating in years involving:

- Significant RSU vesting
- Liquidity events
- Extraordinary bonuses
- Large capital gains

DAF contributions require careful planning because deductions for appreciated securities are generally limited to 30% of adjusted gross income. Unused deductions generally may be carried forward for up to five additional tax years.

For clients with substantial philanthropic objectives, charitable planning may provide meaningful tax planning opportunities.

Multi-State Tax Challenges

Remote work has increased the complexity of state taxation.

Common situations include:

- Relocation before a vesting event
- Hybrid work arrangements
- Multi-state employment histories
- Mid-career changes in residency

Equity compensation awards often vest over multiple years. State sourcing rules may require allocation among multiple jurisdictions based on where services were performed during the applicable earning period.

Failure to properly source equity compensation can create:

- Double taxation
- Missed resident credits
- State audit exposure

These issues often become particularly significant when equity compensation reaches several hundred thousand dollars or more.

Conclusion

For many employees of publicly traded companies, equity compensation has become the primary driver of both wealth creation and tax liability. As a result, effective planning increasingly extends beyond traditional wage withholding and annual tax return preparation.

The most significant planning opportunities and risks typically involve:

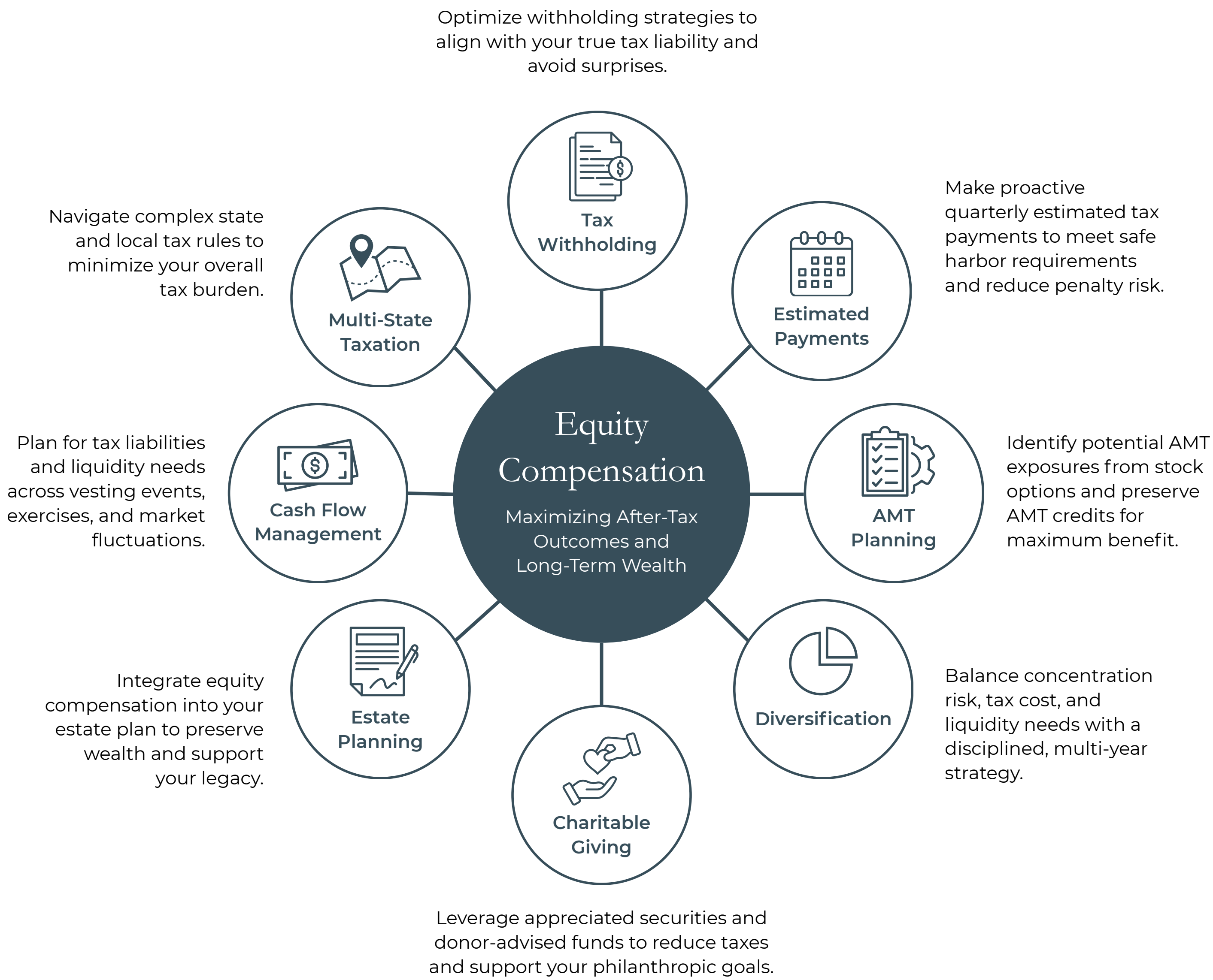
- RSU income recognition and withholding analysis
- Estimated tax and safe harbor compliance
- NSO exercise timing and liquidity management
- ISO exercise strategies and AMT exposure
- ESPP disposition planning
- Tax-efficient diversification of concentrated stock positions
- Charitable gifting of appreciated shares
- Multi-state tax allocation and sourcing

As illustrated in Figure 5, effective equity compensation planning requires coordination across multiple disciplines, including tax, investment, cash flow, charitable, and estate planning. Decisions made in one area frequently affect outcomes in another. For example, an option exercise may influence estimated tax requirements, charitable giving capacity, diversification strategies, and long-term liquidity needs.

As equity compensation continues to represent a meaningful component of executive and technology-sector compensation, a disciplined and integrated planning approach may help support long-term after-tax planning. BakerAvenue can help you develop and implement a long-term equity compensation strategy.

Contact us if you would like guidance navigating the complexities of equity compensation and tax planning.

Figure 5 Equity Compensation Planning Framework



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For more information, please contact us or visit us at bakerave.com.

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BakerAvenue paid fees in connection with obtaining and maintaining its Certified B Corporation status, including an initial licensing fee and ongoing annual licensing fees. Additional information regarding Certified B Corporation standards, certification requirements, and methodology is available from B Lab.

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2023 & 2025

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